

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.

Commission File Number 000-30707

First Northern Community Bancorp

(Exact name of Registrant as specified in its charter)

California
(State or other jurisdiction of incorporation or organization)

68-0450397
(I.R.S. Employer Identification Number)

195 N. First St., Dixon, CA
(Address of principal executive offices)

95620
(Zip Code)

707-678-3041

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, no par value (Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes

No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

(Do not check if smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

The aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant on June 30, 2018 (based upon the last reported sales price of such stock on the OTC Markets on June 30, 2018) was \$146,417,439.

The number of shares of the registrant's Common Stock outstanding as of March 1, 2019 was 11,710,356.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12 (as to security ownership of certain beneficial owners and management), 13 and 14 of Part III incorporate by reference information from the

registrant's proxy statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the registrant's 2018 Annual Meeting of Shareholders.

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NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements, which include forecasts of our financial results and condition, expectations for our operations and business, and our assumptions for those forecasts and expectations. Do not rely unduly on forward-looking statements. Actual results might differ significantly compared to our forecasts and expectations. See Part I, Item 1A. “Risk Factors,” and the other risks described in this report for factors to be considered when reading any forward-looking statements in this filing.

This report includes forward-looking statements, which are subject to the “safe harbor” created by section 27A of the Securities Act of 1933, as amended, and section 21E of the Securities Exchange Act of 1934, as amended. We may make forward-looking statements in our Securities and Exchange Commission (“SEC”) filings, press releases, news articles and when we are speaking on behalf of the Company. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Often, they include the words “believe,” “expect,” “target,” “anticipate,” “intend,” “plan,” “seek,” “estimate,” “potential,” “project,” or words of similar meaning, or future or conditional verbs such as “will,” “would,” “should,” “could,” “might,” or “may.” These forward-looking statements are intended to provide investors with additional information with which they may assess our future potential. All of these forward-looking statements are based on assumptions about an uncertain future and are based on information available to us at the date of these statements. We do not undertake to update forward-looking statements to reflect facts, circumstances, assumptions or events that occur after the date the forward-looking statements are made.

In this document, for example, we make forward-looking statements, which discuss our expectations about:

- Our business objectives, strategies and initiatives, our organizational structure, the growth of our business and our competitive position and prospects, and the effect of competition on our business and strategies
- Our assessment of significant factors and developments that have affected or may affect our results
 - Pending and recent legal and regulatory actions, and future legislative and regulatory developments, including the effects of the Dodd-Frank Wall Street Reform and Protection Act (the “Dodd-Frank Act”) and other legislation and governmental measures introduced in response to the financial crises affecting the banking system, financial markets and the U.S. economy
- Regulatory and compliance controls, processes and requirements and their impact on our business
- The costs and effects of legal or regulatory actions
- Expectations regarding draws on performance letters of credit
- Our regulatory capital requirements, including the capital rules adopted in the past several years by the U.S. federal banking agencies
- Expectations regarding our non-payment of a cash dividend on our common stock in the foreseeable future
- Credit quality and provision for credit losses and management of asset quality and credit risk, and expectations regarding collections
- Our allowances for credit losses, including the conditions we consider in determining the unallocated allowance and our portfolio credit quality, the adequacy of the allowance for loan losses, underwriting standards, and risk grading
- Our assessment of economic conditions and trends and credit cycles and their impact on our business
- The seasonal nature of our business
- The impact of changes in interest rates and our strategy to manage our interest rate risk profile and the possible effect of increases in residential mortgage interest rates on new originations and refinancing of existing residential mortgage loans
- Loan portfolio composition and risk grade trends, expected charge-offs, portfolio credit quality, our strategy regarding troubled debt restructurings (“TDRs”), delinquency rates and our underwriting standards
- Our deposit base including renewal of time deposits
- The impact on our net interest income and net interest margin from the current interest rate environment

- Possible changes in the initiatives and policies of the federal bank regulatory agencies
- Tax rates and the impact of changes in the U.S. tax laws, including the Tax Cuts and Jobs Act
- Our pension and retirement plan costs
- Our liquidity position
- Critical accounting policies and estimates, the impact or anticipated impact of recent accounting pronouncements or changes in accounting principles
- Expected rates of return, maturities, loss exposure, growth rates, yields and projected results
- The possible impact of weather related conditions, including drought, fire or flooding, seismic events, and related governmental responses, on economic conditions, especially in the agricultural sector
- Maintenance of insurance coverages appropriate for our operations
- Threats to the banking sector and our business due to cybersecurity issues and attacks and regulatory expectations related to cybersecurity
- Descriptions of assumptions underlying or relating to any of the foregoing

There are numerous risks and uncertainties that could and will cause actual results to differ materially from those discussed in our forward-looking statements. Many of these factors are beyond our ability to control or predict and could have a material adverse effect on our financial condition and results of operations or prospects. Such risks and uncertainties include but are not limited to those listed in this “Note Regarding Forward-Looking Statements,” Part I, Item 1A “Risk Factors,” Part II and Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Readers of this document should not rely unduly on forward-looking information and should consider all uncertainties and risks disclosed throughout this document and in our other reports to the SEC, including, but not limited to, those discussed below. Any factor described in this report could by itself, or together with one or more other factors, adversely affect our business, future prospects, results of operations or financial condition. We do not undertake to update forward-looking statements to reflect facts, circumstances, assumptions or events that occur after the date the forward-looking statements are made.

PART I

ITEM 1 - BUSINESS

General

First Northern Community Bancorp (the “Company”) is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (“BHCA”). Its legal headquarters and principal administrative offices are located at 195 N. First Street, Dixon, CA 95620 and its telephone number is (707) 678-3041. The Company provides a full range of community banking services to individual and corporate customers throughout the California Counties of Solano, Yolo, Placer and Sacramento as well as portions of El Dorado and Contra Costa Counties through its wholly owned subsidiary bank, First Northern Bank of Dixon (“First Northern” or the “Bank”). The Company’s operating policy since inception has emphasized the banking needs of individuals and small to medium sized businesses. In addition, the Bank owns 100% of the capital stock of Yolano Realty Corporation, a subsidiary created for the purpose of managing selected other real estate owned properties.

The Bank was established in 1910 under a California state charter as Northern Solano Bank, and opened for business on February 1st of that year. On January 2, 1912, the First National Bank of Dixon was established under a federal charter, and until 1955, the two entities operated side by side under the same roof and with the same management. In an effort to increase efficiency of operation, reduce operating expense, and improve lending capacity, the two banks were consolidated on April 8, 1955, with the First National Bank of Dixon as the surviving entity. On January 1, 1980, the Bank’s federal charter was relinquished in favor of a California state charter, and the Bank’s name was changed to First Northern Bank of Dixon.

In April of 2000, the shareholders of First Northern approved a corporate reorganization, which provided for the creation of the bank holding company. This reorganization, effected May 19, 2000, enabled the Company to better compete and grow in its competitive and rapidly changing marketplace.

The Bank has ten full service branches located in the cities of Auburn, Davis, Dixon, Fairfield, Roseville, Sacramento, Vacaville, West Sacramento, Winters and Woodland. The Bank has one satellite banking office inside a retirement community in the city of Davis and residential mortgage loan offices in Davis and Sonoma. The Bank engages financial advisors, through Raymond James Financial Services, Inc., who offer non-FDIC insured investment and brokerage services throughout the region from offices strategically located in West Sacramento, Davis and Auburn. The Bank also has a commercial loan office in the Contra Costa County city of Walnut Creek that serves the East Bay Area's small to medium-sized business lending needs. The Bank's operations center is located in Dixon and provides back-office support including information services, central operations, and the central loan department.

The Bank is in the commercial banking business and generates most of its revenue by providing a wide range of products and services to small and middle sized businesses and individuals including accepting demand, interest bearing transaction, savings, and time deposits, and making commercial, consumer, and real estate related loans. It also issues cashier's checks, sells travelers' checks, rents safe deposit boxes, and provides other customary banking services.

First Northern offers a broad range of alternative investment products, fiduciary and other financial services through Raymond James Financial Services, Inc. First Northern also offers equipment leasing, credit cards, merchant card processing, payroll services, and limited international banking services through third parties.

The Bank's principal source of revenue comes from interest income. Interest income is primarily derived from interest and fees on loans and leases, interest on investments, and due from banks interest bearing accounts. For the year ended December 31, 2018, these sources comprised 82%, 12% and 5%, respectively of the Company's interest income.

The Bank is a member of the Federal Deposit Insurance Corporation ("FDIC") and all deposit accounts are insured by the FDIC to the maximum amount permitted by law, currently \$250,000 per depositor. Most of the Bank's deposits are attracted from the market of northern and central Solano County and southern and central Yolo County. The Bank's deposits are not received from a single depositor or group of affiliated depositors, the loss of any one which would have a materially adverse impact on the business of the Bank. A material portion of the Bank's deposits are not concentrated within a single industry group of related industries.

As of December 31, 2018, the Company had consolidated assets of approximately \$1.25 billion, deposits of approximately \$1.12 billion and stockholder's equity of \$112.5 million. The Company and its subsidiaries employed 201 full-time equivalent employees as of December 31, 2018. The Company and the Bank consider their relationship with their employees to be good and have not experienced any interruptions of operations due to labor disagreements.

Available Information

The Company makes available free of charge on its website, www.thatsmybank.com, its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports, as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the SEC. These filings are also accessible on the SEC's website at www.sec.gov. The information found on the Company's website shall not be deemed incorporated by reference by any general statement incorporating by reference this report into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934 and shall not otherwise be deemed filed under such Acts.

The Effect of Government Policy on Banking

The earnings and growth of the Bank are affected not only by local market area factors and general economic conditions, but also by government monetary and fiscal policies. For example, the Board of Governors of the Federal Reserve System ("FRB") influences the supply of money through its open market operations in U.S. Government securities, adjustments to the discount rates applicable to borrowings by depository institutions and others and establishment of reserve requirements against both member and non-member financial institutions' deposits. Such actions significantly affect the overall growth and distribution of loans, investments, and deposits and also affect interest rates charged on loans and paid on deposits. The nature and impact of future changes in such policies on the business and earnings of the Company cannot be predicted. Additionally, state and federal tax policies can impact banking organizations.

Because of the extensive regulation of commercial banking activities in the United States, the business of the Company is particularly susceptible to being affected by the enactment of federal and state legislation which may have the effect of increasing or decreasing the cost of doing business, modifying permissible activities or enhancing the competitive position of other financial institutions. Any change in applicable laws, regulations, or policies may have a material adverse effect on the business, financial condition, or results of operations, or prospects of the Company.

During 2017 and 2018, the Trump Administration appointed new leadership in key positions at the FRB, FDIC, CFPB and other federal banking agencies. New leadership at the FRB has expressed its intentions to explore opportunities to improve the efficiency, transparency and simplicity of its regulatory supervision. On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief and Consumer Protection Act (the “EGRRCPA”) which amended various provisions of the Dodd-Frank Act as well as other federal banking statutes, and generally authorized the FRB to tailor regulation to better reflect the character of the different banking firms that the FRB supervises. In August 2018, the FRB began implementing the EGRRCPA with several interim final rules which, among other things, revised the FRB’s Small Bank Holding Company and Savings and Loan Holding Company Policy Statement (the “policy statement”) to raise the consolidated assets threshold from \$1 billion to \$3 billion, allowing the Company to qualify under the policy statement. This policy statement applies only to bank holding companies with pro forma consolidated assets of less than \$3 billion that (i) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC. This policy statement permits qualifying bank holding companies, such as the Company, to operate with higher levels of debt, facilitating the ability of community banks to issue debt and raise capital. Qualifying bank holding companies, such as the Company, also are permitted to be examined by a Federal banking agency every 18 months (as opposed to every 12 months) and are eligible to use shorter call report forms. Whether and to what extent the EGRRCPA or new legislation, or these leadership changes, will result in additional regulatory initiatives and policies, or modifications of existing regulations and policies, which may impact our business, cannot be predicted at this time.

Supervision and Regulation of Bank Holding Companies

The Company is a bank holding company subject to the Bank Holding Company Act of 1956, as amended (“BHCA”). The Company reports to, registers with, and is subject to supervision and examination by, the FRB. The FRB also has the authority to examine the Company’s subsidiaries. The costs of any examination by the FRB are payable by the Company.

The FRB has significant supervisory, regulatory and enforcement authority over the Company and its affiliates. The FRB requires the Company to maintain certain levels of capital. See “Capital Standards” below for more information. The FRB also has the authority to take enforcement action against any bank holding company that commits any unsafe or unsound practice, or violates certain laws, regulations, or conditions imposed in writing by the FRB. See “Prompt Corrective Action and Other Enforcement Mechanisms” below for more information. Such enforcement powers include the power to assess civil money penalties against any bank holding company violating any provision of the BHCA or any regulation or order of the FRB under the BHCA. Knowing violations of the BHCA or regulations or orders of the FRB can also result in criminal penalties for the company and any individuals participating in such conduct. Under long-standing FRB policy and provisions of the Dodd-Frank Act, bank holding companies are required to act as a source of financial and managerial strength to their subsidiary banks, and to commit resources to support their subsidiary banks. This support may be required at times when a bank holding company may not be able to provide such support.

Under the BHCA, a company generally must obtain the prior approval of the FRB before it exercises a controlling influence over a bank, or acquires, directly or indirectly, more than 5% of the voting shares or substantially all of the assets of any bank or bank holding company. Thus, the Company is required to obtain the prior approval of the FRB before it acquires, merges, or consolidates with any bank or bank holding company. Any company seeking to acquire, merge, or consolidate with the Company also would be required to obtain the prior approval of the FRB.

The Company is generally prohibited under the BHCA from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than banking, managing banks, or providing services to affiliates of the holding company. However, a bank holding company, with the approval of the FRB, may engage, or acquire the voting shares of companies engaged, in activities that the FRB has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. A bank holding company must demonstrate that the benefits to the public of the proposed activity will outweigh the possible adverse effects associated with such activity.

The FRB generally prohibits a bank holding company from declaring or paying a cash dividend which would impose undue pressure on the capital of subsidiary banks or would be funded only through borrowing or other arrangements that might adversely affect a bank holding company’s financial position. The FRB’s policy is that a bank holding company should not continue its existing rate of cash dividends on its common stock unless its net income is sufficient to fully fund each dividend and its prospective rate of earnings retention appears consistent with its capital needs, asset quality, and overall financial condition. The Company is also subject to restrictions relating to the payment of dividends under California corporate law. See “Restrictions on Dividends and Other Distributions” below for additional restrictions on the ability of the Company and the Bank to pay dividends.

Supervision and Regulation of the Bank

The Bank is subject to regulation, supervision and regular examination by the Financial Institutions Division of the California Department of Business Oversight (“DBO”) and the FDIC. The regulations of these agencies affect most aspects of the Bank’s business and prescribe permissible types of loans and investments, the amount of required reserves, requirements for branch offices, the permissible scope of the Bank’s activities and various other requirements. While the Bank is not a member of the FRB, it is directly subject to certain regulations of the FRB dealing with such matters as check clearing activities, establishment of banking reserves, Truth-in-Lending (“Regulation Z”), and Equal Credit Opportunity (“Regulation B”). The Bank is also subject to regulations of (although not direct supervision and examination by) the Consumer Financial Protection Bureau (“CFPB”), which was created by the Dodd-Frank Act. Among the CFPB’s responsibilities are implementing and enforcing federal consumer financial protection laws, reviewing the business practices of financial services providers for legal compliance, monitoring the marketplace for transparency on behalf of consumers and receiving complaints and questions from consumers about consumer financial products and services. The Dodd-Frank Act added prohibitions on unfair, deceptive or abusive acts and practices to the scope of consumer protection regulations overseen and enforced by the CFPB.

The banking industry is also subject to significantly increased regulatory controls and processes regarding Bank Secrecy Act and anti-money laundering laws. In recent years, a number of banks and bank holding companies announced the imposition of regulatory sanctions, including regulatory agreements and cease and desist orders and, in some cases, fines and penalties, by the bank regulators due to failures to comply with the Bank Secrecy Act and other anti-money laundering legislation. In a number of these cases, the fines and penalties have been significant. Failure to comply with these additional requirements may also adversely affect the Bank’s ability to obtain regulatory approvals for future initiatives requiring regulatory approval, including acquisitions.

Under California law, the Bank is subject to various restrictions on, and requirements regarding, its operations and administration including the maintenance of branch offices and automated teller machines, capital and reserve requirements, deposits and borrowings, and investment and lending activities.

California law permits a state chartered bank to invest in the stock and securities of other corporations, subject to a state chartered bank receiving either general authorization or, depending on the amount of the proposed investment, specific authorization from the DBO. Federal banking laws, however, impose limitations on the activities and equity investments of state chartered, federally insured banks. The FDIC rules on investments prohibit a state bank from acquiring an equity investment of a type, or in an amount, not permissible for a national bank. FDIC rules also prohibit a state bank from engaging as a principal in any activity that is not permissible for a national bank, unless the bank is adequately capitalized and the FDIC approves the activity after determining that such activity does not pose a significant risk to the deposit insurance fund. The FDIC rules on activities generally permit subsidiaries of banks, without prior specific FDIC authorization, to engage in those activities that have been approved by the FRB for bank holding companies because such activities are so closely related to banking to be a proper incident thereto. Other activities generally require specific FDIC prior approval, and the FDIC may impose additional restrictions on such activities on a case-by-case basis in approving applications to engage in otherwise impermissible activities.

The USA Patriot Act

Title III of the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“USA Patriot Act”) includes numerous provisions for fighting international money laundering and blocking terrorism access to the U.S. financial system. The USA Patriot Act requires certain additional due diligence and record keeping practices, including, but not limited to, new customers, correspondent and private banking accounts.

Part of the USA Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (“IMLAFATA”). Among its provisions, IMLAFATA requires each financial institution to: (i) establish an anti-money laundering program; (ii) establish appropriate anti-money laundering policies, procedures, and controls; (iii) appoint a Bank Secrecy Act officer responsible for day-to-day compliance; and (iv) conduct independent audits. In addition, IMLAFATA contains a provision encouraging cooperation among financial institutions, regulatory authorities, and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. IMLAFATA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours. IMLAFATA also amends the BHCA and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution’s anti-money laundering activities when reviewing an application under these Acts.

Pursuant to IMLAFATA, the Secretary of the Treasury, in consultation with the heads of other government agencies, has adopted and proposed measures applicable to banks, bank holding companies, and/or other financial institutions. These measures include enhanced record keeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions.

Privacy Restrictions

The Gramm-Leach-Bliley Act (“GLBA”), which became law in 1999, in addition to the previous described changes in permissible non-banking activities permitted to banks, bank holding companies and financial holding companies, also requires financial institutions in the U.S. to provide certain privacy disclosures to customers and consumers, to comply with certain restrictions on the sharing and usage of personally identifiable information, and to implement and maintain commercially reasonable customer information safeguarding standards.

The Company believes that it complies with all provisions of GLBA and all implementing regulations, and that the Bank has developed appropriate policies and procedures to meet its responsibilities in connection with the privacy provisions of GLBA.

California and other state legislatures have adopted privacy laws, including laws prohibiting sharing of customer information without the customer’s prior permission. These laws may make it more difficult for the Company to share information with its marketing partners, reduce the effectiveness of marketing programs, and increase the cost of marketing programs. In June 2018, the State of California enacted, effective January 1, 2020, The California Consumer Privacy Act of 2018. The new law provides consumers with expansive rights and controls over their personal information which is obtained by or shared with “covered businesses”, which will include the Bank and most other banking institutions. Included will be enhanced rights to obtain disclosure of information collected about consumers and the sharing of that information and the rights to request deletion of the information and to opt out of the sale of such information. The Act provides for monetary penalties for violations of its requirements and for its enforcement by the California Attorney General or consumers. The Act does defer to federal law where conflicts may exist. The impact of the Act on our business and that of other banks cannot be determined at this time.

Capital Standards

The FRB and the federal banking agencies have in place guidelines for risk-based capital requirements applicable to U.S. bank holding companies and banks. In July 2013, the FRB and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations and to conform this framework to the guidelines published by the Basel Committee on Banking Supervision (Basel Committee) known as the Basel III Global Regulatory Framework for Capital and Liquidity. The Basel Committee is a committee of banking supervisory authorities from major countries in the global financial system which formulates broad supervisory standards and guidelines relating to financial institutions for implementation on a country-by-country basis. These rules adopted by the FRB and the other federal banking agencies (the U.S. Basel III Capital Rules) replaced the federal banking agencies’ general risk-based capital rules, advanced approaches rule, market risk rule, and leverage rules, in accordance with certain transition provisions.

Banks, such as First Northern, became subject to the new rules on January 1, 2015. The new rules implement higher minimum capital requirements, include a new common equity Tier 1 capital requirement, and establish criteria that instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. When fully phased in by January 1, 2019, the final rules will provide for increased minimum capital ratios as follows: (a) a common equity Tier1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (which is an increase from 4.0%); (c) a total capital ratio of 8%; and (d) a Tier 1 leverage ratio to average consolidated assets of 4%. Under the new rules, in order to avoid certain limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk-based capital requirements (equal to 2.5% of total risk-weighted assets when fully phased in). The phase-in of the capital conservation buffer began January 1, 2016 and was required to be completed by January 1, 2019. First Northern believes that it was in compliance with these requirements at December 31, 2018.

The following tables present the capital ratios for the Company and the Bank as of December 31, 2018 (calculated in accordance with the Basel III capital rules):

	The Company			
	2018		Adequately Capitalized Ratio	
	Capital	Ratio		
Tier 1 Leverage Capital (to Average Assets)	\$ 117,497	9.3%	4.0%	
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	117,497	13.5%	4.5%	
Tier 1 Capital (to Risk-Weighted Assets)	117,497	13.5%	6.0%	
Total Risk-Based Capital (to Risk-Weighted Assets)	128,442	14.7%	8.0%	

	The Bank				
	2018		Adequately Capitalized Ratio	Well Capitalized Ratio	
	Capital	Ratio			
Tier 1 Leverage Capital (to Average Assets)	\$ 114,342	9.0%	4.0%	5.0%	
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	114,342	13.1%	4.5%	6.5%	
Tier 1 Capital (to Risk-Weighted Assets)	114,342	13.1%	6.0%	8.0%	
Total Risk-Based Capital (to Risk-Weighted Assets)	125,287	14.4%	8.0%	10.0%	

The federal banking agencies must take into consideration concentrations of credit risk and risks from non-traditional activities, as well as an institution's ability to manage those risks, when determining the adequacy of an institution's capital. This evaluation will be made as a part of the institution's regular safety and soundness examination. The federal banking agencies must also consider interest rate risk (when the interest rate sensitivity of an institution's assets does not match the sensitivity of its liabilities or its off-balance-sheet position) in evaluating a Bank's capital adequacy.

In January 2014, the Basel Committee issued an updated version of its leverage ratio and disclosure guidance. The Basel Committee guidance continues to set a minimum Basel III leverage ratio of 3%. The Basel III leverage ratio was subject to further calibration until 2017, with final implementation expected in 2018. The Basel Committee collected data during this observation period to assess whether a minimum leverage ratio of 3% is appropriate over a full credit cycle and for various types of business models and to assess the impact of using common equity tier 1 capital or total regulatory capital as the numerator. The Basel Committee, in December 2017, adopted further revisions to the Basel III capital standards which have not yet been adopted by the U.S. bank regulation.

Prompt Corrective Action and Other Enforcement Mechanisms

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") requires each federal banking agency to take prompt corrective action to resolve the problems of insured depository institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. The law required each federal banking agency to promulgate regulations defining the following five categories in which an insured depository institution will be placed, based on the level of its capital ratios: well capitalized, adequately capitalized, under-capitalized, significantly undercapitalized, and critically undercapitalized.

Under the prompt corrective action provisions of FDICIA, an insured depository institution generally will be classified in one of five capital categories ranging from "well-capitalized" to "critically under-capitalized."

An institution that, based upon its capital levels, is classified as "well capitalized," "adequately capitalized" or "under-capitalized" may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions. Management believes that at December 31, 2018, the Company and the Bank exceeded the required ratios for classification as "well capitalized." Institutions that are "under-capitalized" or lower are subject to certain mandatory supervisory corrective actions. Failure to meet regulatory capital guidelines can result in a bank being required to raise additional capital. An "under-capitalized" bank must develop a capital restoration plan and its parent holding company must guarantee compliance with the plan subject to certain limits.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the agency would be harmed if such equitable relief was not granted. Additionally, a holding company's inability to serve as a source of strength to its subsidiary banking organizations could serve as an additional basis for a regulatory action against the holding company.

Safety and Soundness Standards

FDICIA also implemented certain specific restrictions on transactions and required federal banking regulators to adopt overall safety and soundness standards for depository institutions related to internal control, loan underwriting and documentation and asset growth. Among other things, FDICIA limits the interest rates paid on deposits by undercapitalized institutions, restricts the use of brokered deposits, limits the aggregate extensions of credit by a depository institution to an executive officer, director, principal shareholder, or related interest, and reduces deposit insurance coverage for deposits offered by undercapitalized institutions for deposits by certain employee benefits accounts.

The federal banking agencies may require an institution to submit to an acceptable compliance plan as well as have the flexibility to pursue other more appropriate or effective courses of action given the specific circumstances and severity of an institution's non-compliance with one or more standards.

Restrictions on Dividends and Other Distributions

The power of the board of directors of an insured depository institution to declare a cash dividend or other distribution with respect to capital is subject to statutory and regulatory restrictions which limit the amount available for such distribution depending upon the earnings, financial condition and liquidity needs of the institution, as well as general business conditions. FDICIA prohibits insured depository institutions from paying management fees to any controlling persons or, with certain limited exceptions, making capital distributions, including dividends, if, after such transaction, the institution would be undercapitalized.

The federal banking agencies also have authority to prohibit a depository institution from engaging in business practices, which are considered to be unsafe or unsound, possibly including payment of dividends or other payments under certain circumstances even if such payments are not expressly prohibited by statute.

In addition to the restrictions imposed under federal law, banks chartered under California law generally may only pay cash dividends to the extent such payments do not exceed the lesser of retained earnings of the bank's net income for its last three fiscal years (less any distributions to shareholders during such period). In the event a bank desires to pay cash dividends in excess of such amount, the bank may pay a cash dividend with the prior approval of the DBO in an amount not exceeding the greatest of the bank's retained earnings, the bank's net income for its last fiscal year, or the bank's net income for its current fiscal year.

Premiums for Deposit Insurance

The Bank is a member of the Deposit Insurance Fund ("DIF") maintained by the FDIC. Through the DIF, the FDIC insures the deposits of the Bank up to prescribed limits for each depositor. To maintain the DIF, member institutions are assessed an insurance premium based on their deposits and their institutional risk category. The FDIC determines an institution's risk category by combining its supervisory ratings with its financial ratios and other risk measures. The FDIC also has the authority to impose special assessments at any time it estimates that DIF reserves could fall to a level that would adversely affect public confidence. In October 2010, the FDIC adopted a comprehensive, long-range "restoration" plan for the DIF to better ensure the adequacy of the ratio of the fund's reserves to insured deposits. There can be no assurance that the FDIC will not impose special assessments or increase annual assessments in the future.

Community Reinvestment Act and Fair Lending

The Bank is subject to certain fair lending requirements and reporting obligations involving its home mortgage lending operations and is also subject to the Community Reinvestment Act ("CRA"). The CRA generally requires the federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of the Bank's local communities, including low- and moderate-income neighborhoods. In addition to substantive penalties and corrective measures that may be required for a violation of certain fair lending laws, the federal banking agencies may take compliance with such laws and CRA into account when reviewing other activities by the Bank, particularly applications involving business expansion such as acquisitions or de novo branching.

Certain CFPB Rules

The Consumer Financial Protection Bureau (CFPB) has adopted an Ability-to-Repay rule that all newly originated residential mortgages must meet. The Ability-to-Repay rule establishes guidelines that the lender must follow when reviewing an applicant's income, obligations, assets, liabilities, and credit history and requires that the lender make a reasonable and good faith determination of an applicant's ability to repay the loan according to its terms. Lenders will be presumed to have met the Ability-to-Repay rule by originating loans that meet the criteria for "Qualified Mortgages", which are set forth in detail in the rule. The mortgage loans originated by the Bank with the intent to sell them to Freddie Mac meet the Qualified Mortgage criteria.

The CFPB has also adopted a rule on simplified and improved mortgage loan disclosures, otherwise known as Know Before You Owe. The rule provides that mortgage borrowers receive a loan estimate three business days after application and a closing disclosure three days before closing. These forms will replace disclosure forms previously provided to borrowers under other provisions of federal law. The rule provides for limitations on application fees and increases in closing costs.

These rules and any new regulatory requirements promulgated by the CFPB could have an adverse impact on our residential mortgage lending business as the industry adapts to the rule and any additional regulations. Our business strategy, product offerings and profitability may change as the market adjusts to the new rules and any additional regulations and as these requirements are interpreted by the regulators and courts.

Conservatorship and Receivership of Insured Depository Institutions

If any insured depository institution becomes insolvent and the FDIC is appointed its conservator or receiver, the FDIC may, under federal law, disaffirm or repudiate any contract to which such institution is a party, if the FDIC determines that performance of the contract would be burdensome, and that disaffirmance or repudiation of the contract would promote the orderly administration of the institution's affairs. Such disaffirmance or repudiation would result in a claim by its holder against the receivership or conservatorship. The amount paid upon such claim would depend upon, among other factors, the amount of receivership assets available for the payment of such claim and its priority relative to the priority of others. In addition, the FDIC as conservator or receiver may enforce most contracts entered into by the institution notwithstanding any provision providing for termination, default, acceleration, or exercise of rights upon or solely by reason of insolvency of the institution, appointment of a conservator or receiver for the institution, or exercise of rights or powers by a conservator or receiver for the institution. The FDIC as conservator or receiver also may transfer any asset or liability of the institution without obtaining any approval or consent of the institution's shareholders or creditors.

The Dodd-Frank Act

On July 21, 2010, the Dodd-Frank Act was signed into law. This sweeping legislation has affected U.S. financial institutions, including us, in many ways, some of which have increased, or may increase in the future, the cost of doing business and have presented other challenges to the financial services industry. Many of the law's provisions have been implemented by rules and regulations of the federal banking agencies, but certain provisions of the law are yet to be implemented and, therefore, the full scope and impact of the law on banking institutions generally and on our business cannot be fully determined at this time. The law contains many provisions which may have particular relevance to our business, including provisions that have resulted in adjustments to our FDIC deposit insurance premiums and that can be expected to result in increased capital and liquidity requirements, increased supervision, increased regulatory and compliance risks and costs and other operational costs and expenses, reduced fee-based revenues and restrictions on some aspects of our operations, and increased interest expense on our demand deposits.

The environment in which financial institutions continue to operate since the U.S. financial crisis, including legislative and regulatory changes affecting capital, liquidity, supervision, permissible activities, corporate governance and compensation, and changes in fiscal policy may have long-term effects on the business model and profitability of financial institutions that cannot now be foreseen.

Overdraft and Interchange Fees

The FRB's Regulation E imposes restrictions on banks' abilities to charge overdraft services and fees. The rule prohibits financial institutions from charging fees for paying overdrafts on ATM and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The Dodd-Frank Act, through a provision known as the Durbin Amendment, required the FRB to establish standards for interchange fees that are "reasonable and proportional" to the cost of processing the debit card transaction and imposes other requirements on card networks. Under the rule, the maximum permissible interchange fee that a bank may receive is the sum of \$0.21 per transaction and five basis points multiplied by the value of the transaction, with an additional upward adjustment of no more than \$0.01 per transaction if a bank develops and implements policies and procedures reasonably designed to achieve fraud-prevention standards set by regulation. The FRB's regulation is resulting in decreased revenues and increased compliance costs for the banking industry and the Bank, and there can be no assurance that alternative sources of revenues can be implemented to offset the impact of these developments.

Interest on Demand Deposits

On July 21, 2011, the FRB's final rule repealing Regulation Q's prohibition against the payment of interest on demand deposit accounts became effective. Over time, permitting the payment of interest on business checking accounts could have a significant impact on our commercial deposit business.

Sarbanes – Oxley Act

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") implemented a broad range of corporate governance and accounting measures to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of disclosures under federal securities laws. Among other things, Sarbanes-Oxley and its implementing regulations established new membership requirements and additional responsibilities for our audit committee, imposed restrictions on the relationship between us and our outside auditors (including restrictions on the types of non-audit services our auditors may provide to us), imposed additional responsibilities for our external financial statements on our chief executive officer and chief financial officer, expanded the disclosure requirements for our corporate insiders and contained new evaluation, auditing and reporting requirements relating to disclosure controls and procedures and our internal control over financial reporting.

Possible Future Legislation and Regulatory Initiatives

The recent economic and political environment has led to a number of proposed legislative, governmental and regulatory initiatives, described above, that may significantly impact our industry. These and other initiatives could significantly change the competitive and operating environment in which we and our subsidiaries operate. We cannot predict whether these or any other proposals will be enacted or the ultimate impact of any such initiatives on our operations, competitive situation, financial condition or results of operations.

Competition

In the past, an independent bank's principal competitors for deposits and loans have been other banks (particularly large financial institutions that have substantial capital, technology and marketing resources, which are well in excess of ours, although these larger institutions may be required to hold more regulatory capital and as a result, achieve lower returns on equity), savings and loan associations, and credit unions. For agricultural loans, the Bank also competes with constituent entities with the Federal Farm Credit System. To a lesser extent, competition is also provided by thrift and loans, mortgage brokerage companies and insurance companies. Other institutions, such as brokerage houses, mutual fund companies, credit card companies, and even retail establishments have offered new investment vehicles, which also compete with banks for deposit business. Additionally, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and payment systems. We also experience competition, especially for deposits, from internet-based banking institutions and other financial companies, which do not always have a presence in our market footprint and have grown rapidly in recent years.

Current federal law has made it easier for out-of-state banks to enter and compete in the states in which we operate. Competition in our principal markets may further intensify as a result of the Dodd-Frank Act which, among other things, permits out-of-state de novo branching by national banks, state banks and foreign banks from other states. While the impact of these changes, and of other proposed changes, cannot be predicted with certainty, it is clear that the business of banking in California will remain highly competitive.

We also compete for deposits and loans with much larger financial institutions. Competition in our industry is likely to further intensify as a result of continued consolidation of financial services companies, including large consolidations of significance in our market area. In order to compete with major financial institutions and other competitors in its primary service areas, the Bank relies upon the experience of its executive and senior officers in serving business clients, and upon its specialized services, local promotional activities and the personal contacts made by its officers, directors and employees.

For customers whose loan demand exceeds the Bank's legal lending limit, the Bank may arrange for such loans on a participation basis with correspondent banks. The seasonal swings discussed earlier have, in the past, had some impact on the Bank's liquidity. The management of investment maturities, sale of loan participations, federal fund borrowings, qualification for funds under the Federal Reserve Bank's seasonal credit program, and the ability to sell mortgages in the secondary market is intended to allow the Bank to satisfactorily manage its liquidity.

ITEM 1A – RISK FACTORS

In addition to factors mentioned elsewhere in this Report, the factors contained below, among others, could cause our financial condition and results of operations to be materially and adversely affected. If this were to happen, the value of our common stock could decline, perhaps significantly, and you could lose all or part of your investment.

U.S. and global economies continue to experience significant challenges.

In the past decade, adverse financial developments impacted the U.S. and global economies and financial markets and present challenges for the banking and financial services industry and for us. These developments included a general recession both globally and in the U.S. accompanied by substantial volatility in the financial markets.

In response, various significant economic and monetary stimulus measures were enacted by the U.S. Congress. The FRB also pursued a highly accommodative monetary policy aimed at keeping interest rates at historically low levels although the FRB has begun to modify certain aspects of this policy by gradually increasing short-term interest rates and reducing its balance sheet. U.S. economic activity has shown substantial improvement, but there can be no assurance that this progress will continue or will not reverse. If, notwithstanding the government's fiscal and monetary measures, the U.S. economy were to become subject to a recessionary condition for an extended period, this would present additional significant challenges for the U.S. banking and financial services industry and for us. In the U.S. federal budget deficits have continued to increase and the national debt has reached historically high levels in absolute terms. Disagreements between the Administration and the Congress have continued to occur regarding the funding of the federal government. The long-term impact of this situation cannot be predicted.

The Bank is Subject to Lending Risks of Loss and Repayment Associated with Commercial Banking Activities which could Adversely Affect the Bank's Financial Condition and Results of Operations

The Bank's business strategy is to focus on commercial business loans (which includes agricultural loans), construction loans, and commercial and multi-family real estate loans. The principal factors affecting the Bank's risk of loss in connection with commercial business loans include the borrower's ability to manage its business affairs and cash flows, general economic conditions and, with respect to agricultural loans, weather and climate conditions. In recent years, California has experienced severe drought conditions. While rainfall levels have improved considerably since 2015, there can be no assurance that the drought will not return with consequent difficulties for the California economy and our commercial loan customers, particularly in the agricultural sector. Loans secured by commercial real estate are generally larger and involve a greater degree of credit and transaction risk than residential mortgage (one to four family) loans. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on successful operation or management of the underlying properties, repayment of such loans may be dependent on factors other than the prevailing conditions in the real estate market or the economy. Real estate construction financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value at completion of construction or development compared to the estimated cost (including interest) of construction. If the estimate of value proves to be inaccurate, the Bank may be confronted with a project which, when completed, has a value which is insufficient to assure full repayment of the construction loan.

Although the Bank manages lending risks through its underwriting and credit administration policies, no assurance can be given that such risks will not materialize, in which event, the Company's financial condition, results of operations, cash flows, and business prospects could be materially adversely affected.

Increases in the Allowance for Loan Losses Would Adversely Affect the Bank's Financial Condition and Results of Operations

The Bank's allowance for estimated losses on loans was approximately \$12.8 million, or 1.65% of total loans, at December 31, 2018, compared to \$11.1 million, or 1.49% of total loans, at December 31, 2017, and 250.4% of total non-performing loans net of guaranteed portions at December 31, 2018, compared to 300.1% of total non-performing loans, net of guaranteed portions at December 31, 2017. Material future additions to the allowance for estimated losses on loans may be necessary if material adverse changes in economic conditions occur and the performance of the Bank's loan portfolio deteriorates. In addition, an allowance for losses on other real estate owned may also be required in order to reflect changes in the markets for real estate in which the Bank's other real estate owned is located and other factors which may result in adjustments which are necessary to ensure that the Bank's foreclosed assets are carried at the lower of cost or fair value, less estimated costs to dispose of the properties. Moreover, the FDIC and the DBO, as an integral part of their examination process, periodically review the Bank's allowance for estimated losses on loans and the carrying value of its assets. Increases in the provisions for estimated losses on loans and foreclosed assets would adversely affect the Bank's financial condition and results of operations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Summary of Loan Loss Experience" below.

The Bank's Dependence on Real Estate Lending Increases Our Risk of Losses

At December 31, 2018, approximately 78% of the Bank's loans in principal amount (excluding loans held-for-sale) were secured by real estate. The value of the Bank's real estate collateral has been, and could in the future continue to be, adversely affected by the economic recession and resulting adverse impact on the real estate market in Northern California.

The Bank's primary lending focus has historically been commercial (including agricultural), construction, and real estate mortgage. At December 31, 2018, real estate mortgage (excluding loans held-for-sale) and construction loans (residential and other) comprised approximately 74% and 4%, respectively, of the total loans in the Bank's portfolio. At December 31, 2018, all of the Bank's real estate mortgage and construction loans and approximately 1% of its commercial loans were secured fully or in part by deeds of trust on underlying real estate. The Company's dependence on real estate increases the risk of loss in both the Bank's loan portfolio and its holdings of other real estate owned if economic conditions in Northern California deteriorate in the future. Deterioration of the real estate market in Northern California would have a material adverse effect on the Company's business, financial condition, and results of operations.

The CFPB has adopted various regulations which have impacted, and will continue to impact, our residential mortgage lending business. For additional information, see "Business – Certain CFPB Rules" in Item 1 of this Report on Form 10-K.

See "U.S. and global economies continue to experience significant challenges" above, and "Adverse California Economic Conditions Could Adversely Affect the Bank's Business" below.

Adverse economic factors affecting certain industries the Bank serves could adversely affect our business.

We are subject to certain industry specific economic factors. For example, a portion of the Bank's total loan portfolio is related to residential and commercial real estate, especially in California. Increases in residential mortgage loan interest rates could have an adverse effect on the Bank's operations by depressing new mortgage loan originations, which in turn could negatively impact the Bank's title and escrow deposit levels. Additionally, a further downturn in the residential real estate and housing industries in California could have an adverse effect on the Bank's operations and the quality of its real estate and construction loan portfolio. Although the Bank does not engage in subprime or negative amortization lending, effects of recent subprime market challenges, combined with the ongoing challenges in the U.S. and California real estate markets, could result in further price reductions in single family home prices and a lack of liquidity in refinancing markets. These factors could adversely impact the quality of the Bank's residential construction, residential mortgage and construction related commercial portfolios in various ways, including by decreasing the value of the collateral for our loans. These factors could also negatively affect the economy in general and thereby the Bank's overall loan portfolio.

The Bank provides financing to, and receives deposits from, businesses in a number of other industries that may be particularly vulnerable to industry-specific economic factors, including the home building, commercial real estate, retail, agricultural, industrial, and commercial industries. The home building industry in California has been especially adversely impacted by the deterioration in residential real estate markets, which has lead the Bank to take additional provisions and charge-offs against credit losses in this portfolio. Continued increases in fuel prices and energy costs and the continuation of the drought in California could adversely affect businesses in several of these industries. Recent wildfires across California and in our market area have resulted in significant damage and destruction of property and equipment. The fire damage caused may result in adverse economic impacts to those affected markets and beyond and on our customers. Industry specific risks are beyond the Bank's control and could adversely affect the Bank's portfolio of loans, potentially resulting in an increase in non-performing loans or charge-offs and a slowing of growth or reduction in our loan portfolio.

The effects of changes or increases in, or supervisory enforcement of, banking or other laws and regulations or governmental fiscal or monetary policies could adversely affect us.

We are subject to significant federal and state banking regulation and supervision, which is primarily for the benefit and protection of our customers and the Deposit Insurance Fund and not for the benefit of investors in our securities. In the past, our business has been materially affected by these regulations. This will continue and likely intensify in the future. Laws, regulations or policies, including accounting standards and interpretations, currently affecting us may change at any time. Regulatory authorities may also change their interpretation of and intensify their examination of compliance with these statutes and regulations. Therefore, our business may be adversely affected by changes in laws, regulations, policies or interpretations or regulatory approaches to compliance and enforcement, as well as by supervisory action or criminal proceedings taken as a result of noncompliance, which could result in the imposition of significant civil money penalties or fines. Changes in laws and regulations may also increase our expenses by imposing additional supervision, fees, taxes or restrictions on our operations. Compliance with laws and regulations, especially new laws and regulations, increases our operating expenses and may divert management attention from our business operations.

On July 21, 2010, President Obama signed into law the Dodd-Frank Act. This important legislation has affected U.S. financial institutions in many ways, some of which have increased, or may increase in the future, the cost of doing business and present other challenges to the financial services industry. Many provisions of the law have been implemented by rules and regulations of the federal banking agencies, but certain provisions of the law are yet to be implemented by the federal banking agencies and therefore the full scope and impact of the law on banking institutions generally and on our business cannot be fully determined at this time. The law contains many provisions that may have particular relevance to the business of the Bank. While the full effect of these provisions of the Dodd-Frank Act on the Bank cannot be predicted at this time, they have resulted in adjustments to our FDIC deposit insurance premiums, and have resulted in increased capital and liquidity requirements, increased supervision, increased regulatory and compliance risks and costs and other operational costs and expenses, reduced fee-based revenues and restrictions on some aspects of our operations, some or all of which may be material.

Proposals to reform the housing finance market in the U.S. could also significantly affect our business. These proposals, among other things, consider reducing or eliminating over time the role of the GSEs in guaranteeing mortgages and providing funding for mortgage loans, as well as the implementation of reforms relating to borrowers, lenders, and investors in the mortgage market, including reducing the maximum size of a loan that the GSEs can guarantee, phasing in a minimum down payment requirement for borrowers, improving underwriting standards, and increasing accountability and transparency in the securitization process.

While the specific nature of these reforms and their impact on the financial services industry in general, and on the Bank in particular, is uncertain at this time, such reforms, if enacted, are likely to have a substantial impact on the mortgage market and could potentially reduce our income from mortgage originations by increasing mortgage costs or lowering originations. The GSE reforms could also reduce real estate prices, which could reduce the value of collateral securing outstanding mortgage loans. This reduction of collateral value could negatively impact the value or perceived collectability of these mortgage loans and may increase our allowance for loan losses. Such reforms may also include changes to the Federal Home Loan Bank System, which could adversely affect a significant source of term funding for lending activities by the banking industry, including the Bank. These reforms may also result in higher interest rates on residential mortgage loans, thereby reducing demand, which could have an adverse impact on our residential mortgage lending business.

In July 2013, the FRB and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations. For additional information, see "Business-Capital Standards" in Item 1 of this Form 10-K.

We maintain systems and procedures designed to comply with applicable laws and regulations. However, some legal/regulatory frameworks provide for the imposition of criminal or civil penalties (which can be substantial) for noncompliance. In some cases, liability may attach even if the noncompliance was inadvertent or unintentional and even if compliance systems and procedures were in place at the time. There may be other negative consequences from a finding of noncompliance, including restrictions on certain activities and damage to our reputation.

Additionally, our business is affected significantly by the fiscal and monetary policies of the U.S. federal government and its agencies. We are particularly affected by the policies of the FRB, which regulates the supply of money and credit in the U.S. Under the Dodd-Frank Act and a long-standing policy of the FRB, a bank holding company is expected to act as a source of financial and managerial strength for its subsidiary banks. As a result of that policy, we may be required to commit financial and other resources to our subsidiary bank in circumstances where we might not otherwise do so. Among the instruments of monetary policy available to the FRB are (a) conducting open market operations in U.S. Government securities, (b) changing the discount rates on borrowings by depository institutions and the federal funds rate, and (c) imposing or changing reserve requirements against certain borrowings by banks and their affiliates. These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. The policies of the FRB may have a material effect on our business, prospects, results of operations and financial condition.

Refer to "Business – Supervision and Regulation of Bank Holding Companies" and "Business – Supervision and Regulation of the Bank" in Item 1 of this Form 10-K for discussion of certain existing and proposed laws and regulations that may affect our business.

Adverse California Economic Conditions Could Adversely Affect the Bank's Business

The Bank's operations and a substantial majority of the Bank's assets and deposits are generated and concentrated primarily in Northern California, particularly the counties of Placer, Sacramento, Solano and Yolo, and are likely to remain so for the foreseeable future. At December 31, 2018, approximately 78% of the Bank's loan portfolio in principal amount (excluding loans held-for-sale) consisted of real estate-related loans, all of which were secured by collateral located in Northern California. As a result, a downturn in the economic conditions in Northern California may cause the Bank to incur losses associated with high default rates and decreased collateral values in its loan portfolio. Economic conditions in California are subject to various uncertainties including deterioration in the California real estate market and housing industry.

At times, economic conditions in California, and especially the regional markets we serve, have been subject to various challenges, including significant deterioration in the residential real estate sector and the California state government's budgetary and fiscal difficulties. While California home prices and the California economy in general have experienced a recovery in recent years, there can be no assurance that the recovery will continue. Recent growth in home prices in some California markets may be unsustainable relative to market fundamentals, and home price declines may occur.

In addition, until 2013, the State government of California experienced budget shortfalls or deficits that led to protracted negotiations between the Governor and the State Legislature over how to address the budget gap. The California electorate approved, in the 2012 general elections, certain increases in the rate of income taxation in California. However, there can be no assurance that the state's fiscal and budgetary challenges will not recur. In addition, the impact of increased rates of income taxation on the level of economic activity in California cannot be predicted at this time.

Also, municipalities and other governmental units within California have been experiencing budgetary difficulties, and several California municipalities have filed for protection under the Bankruptcy Code. As a result, concerns also have arisen regarding the outlook for the State of California's governmental obligations, as well as those of California municipalities and other governmental units.

Poor economic conditions in California, and especially the regional markets we serve, will cause us to incur losses associated with higher default rates and decreased collateral values in our loan portfolio. If the budgetary and fiscal difficulties of the California State government and California municipalities and other governmental units were to recur or economic conditions in California decline, we expect that our level of problem assets will increase and our prospects for growth will be impaired.

The Bank is Subject to Interest Rate Risk

The income of the Bank depends to a great extent on "interest rate differentials" and the resulting net interest margins (i.e., the difference between the interest rates earned on the Bank's interest-earning assets such as loans and investment securities, and the interest rates paid on the Bank's interest-bearing liabilities such as deposits and borrowings). These rates are highly sensitive to many factors, which are beyond the Bank's control, including, but not limited to, general economic conditions and the policies of various governmental and regulatory agencies, in particular, the FRB. We cannot predict with any certainty the nature and impact of such policies. Changes in the relationship between short-term and long-term market interest rates or between different interest rate indices can also impact our interest rate differential, possibly resulting in a decrease in our interest income relative to interest expense. In addition, changes in monetary policy, including changes in interest rates, influence the origination of loans, the purchase of investments and the generation of deposits and affect the rates received on loans and investment securities and paid on deposits, which could have a material adverse effect on the Company's business, financial condition, and results of operations.

Our Ability to Pay Dividends is Subject to Legal Restrictions

As a bank holding company, our cash flow typically comes from dividends of the Bank. Various statutory and regulatory provisions restrict the amount of dividends the Bank can pay to the Company without regulatory approval. The ability of the Company to pay cash dividends in the future also depends on the Company's profitability, growth, and capital needs. In addition, California law restricts the ability of the Company to pay dividends. For a number of years, the Company has paid stock dividends, but not cash dividends, to its customers. No assurance can be given that the Company will pay any dividends in the future or, if paid, such dividends will not be discontinued. See "Business - Restrictions on Dividends and Other Distributions" above.

Competition Adversely Affects our Profitability

In California generally, and in the Bank's primary market area specifically, major banks dominate the commercial banking industry. By virtue of their larger capital bases, such institutions have substantially greater lending limits than those of the Bank. Competition is likely to further intensify as a result of recent adverse economic and financial market conditions which have led to increased consolidation of financial services companies, including large consolidations of significance in our market area. In obtaining deposits and making loans, the Bank competes with these larger commercial banks and other financial institutions, such as savings and loan associations, credit unions and member institutions of the Farm Credit System, which offer many services that traditionally were offered only by banks. Using the financial holding company structure, insurance companies, and securities firms may compete more directly with banks and bank holding companies. In addition, the Bank competes with other institutions such as mutual fund companies, brokerage firms, and even retail stores seeking to penetrate the financial services market. Current federal law has also made it easier for out-of-state banks to enter and compete in the states in which we operate. Competition in our principal markets may further intensify as a result of the Dodd-Frank Act which, among other things, permits out-of-state de novo branching by national banks, state banks and foreign banks from other states. Also, technology and other changes increasingly allow parties to complete financial transactions electronically, and in many cases, without banks. For example, consumers can pay bills and transfer funds over the internet and by telephone without banks. Non-bank financial service providers may have lower overhead costs and are subject to fewer regulatory constraints. If consumers do not use banks to complete their financial transactions, we could potentially lose fee income, deposits and income generated from those deposits. During periods of declining interest rates, competitors with lower costs of capital may solicit the Bank's customers to refinance their loans. Furthermore, during periods of economic slowdown or recession, the Bank's borrowers may face financial difficulties and be more receptive to offers from the Bank's competitors to refinance their loans. No assurance can be given that the Bank will be able to compete with these lenders. See "Business - Competition" above.

Government Regulation and Legislation Could Adversely Affect the Company

The Company and the Bank are subject to extensive state and federal regulation, supervision, and legislation, which govern almost all aspects of the operations of the Company and the Bank. The business of the Bank is particularly susceptible to being affected by the enactment of federal and state legislation, which may have the effect of increasing the cost of doing business, modifying permissible activities, or enhancing the competitive position of other financial institutions. Such laws are subject to change from time to time and are primarily intended for the protection of consumers, depositors and the Deposit Insurance Fund and not for the benefit of shareholders of the Company. Regulatory authorities may also change their interpretation of these laws and regulations. The Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on the business and prospects of the Company, but it could be material and adverse. See “Business – Supervision and Regulation of the Bank” and “The effects of changes or increases in, or supervisory enforcement of, banking or other laws and regulations or governmental fiscal or monetary policies could adversely affect us” above.

We maintain systems and procedures designed to comply with applicable laws and regulations. However, some legal/regulatory frameworks provide for the imposition of criminal or civil penalties (which can be substantial) for non-compliance. In some cases, liability may attach even if the non-compliance was inadvertent or unintentional and even if compliance systems and procedures were in place at the time. There may be other negative consequences from a finding of non-compliance, including restrictions on certain activities and damage to the Company’s reputation.

Our Controls and Procedures May Fail or be Circumvented Which Could Have a Material Adverse Effect on the Company’s Financial Condition or Results of Operations

The Company maintains controls and procedures to mitigate against risks such as processing system failures and errors, and customer or employee fraud, and maintains insurance coverage for certain of these risks. Any system of controls and procedures, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Events could occur which are not prevented or detected by the Company’s internal controls or are not insured against or are in excess of the Company’s insurance limits. Any failure or circumvention of the Company’s controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company’s business, results of operations and financial condition.

Changes in Deposit Insurance Premiums Could Adversely Affect Our Business

As discussed above in Part I under the caption “Business – Premiums for Deposit Insurance,” the FDIC adopted a comprehensive, long-range “restoration” plan for the Deposit Insurance Fund to ensure that the ratio of the fund’s reserves to insured deposits reaches 1.35 percent by 2020, as required by the Dodd-Frank Act. The FDIC could further increase deposit premiums or impose special assessments in the future. Any further increases in the deposit insurance assessments the Bank pays would further increase our costs.

Negative Public Opinion Could Damage Our Reputation and Adversely Affect Our Earnings

Reputational risk, or the risk to our earnings and capital from negative public opinion, is inherent in our business. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, management of actual or potential conflicts of interest and ethical issues, and our protection of confidential client information. Negative public opinion can adversely affect our ability to keep and attract customers and employees and can expose us to litigation and regulatory action. We take steps to minimize reputation risk in the way we conduct our business activities and deal with our clients and communities.

We may not be able to hire or retain additional qualified personnel and recruiting and compensation costs may increase as a result of turnover, both of which may increase costs and reduce profitability and may adversely impact our ability to implement our business strategy.

Our success depends upon the ability to attract and retain highly motivated, well-qualified personnel. We face significant competition in the recruitment and retention of qualified employees. Executive compensation in the financial services sector has been controversial and the subject of regulation. The FDIC has proposed rules which would increase deposit premiums for institutions with compensation practices deemed to increase risk to the institution. Over time, this guidance and the proposed rules, upon their adoption, could have the effect of making it more difficult for banks to attract and retain skilled personnel.

We may be adversely affected by unpredictable catastrophic events or terrorist attacks and our business continuity and disaster recovery plans may not adequately protect us from serious disaster.

The occurrence of catastrophic events such as wildfires, earthquakes, flooding or other large-scale catastrophes and terrorist attacks could adversely affect our business, financial condition or results of operations if a catastrophe rendered both our production data center in Sacramento and our recovery data center in Las Vegas unusable. Although we enhanced our disaster recovery capabilities in 2017 through the completion of the new, out of region backup center in Las Vegas, there can be no assurance that our current disaster recovery plans and capabilities will protect us from serious disaster.

Changes in Accounting Standards Could Materially Impact Our Financial Statements

The Company's consolidated financial statements are presented in accordance with accounting principles generally accepted in the United States of America, called GAAP. The financial information contained within our consolidated financial statements is, to a significant extent, financial information that is based on approximate measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. Along with other factors, we use historical loss factors to determine the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical loss factors that we use. Other estimates that we use are fair value of our securities and expected useful lives of our depreciable assets. We have not entered into derivative contracts for our customers or for ourselves, which relate to interest rate, credit, equity, commodity, energy, or weather-related indices. From time to time, the FASB and SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be operationally complex to implement and can materially impact how we record and report our financial condition and results of operations. For example, in June 2016, the FASB issued Accounting Standards Update 2016-13, Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), that will, effective January 1, 2020, substantially change the accounting for credit losses on loans and other financial assets held by banks, financial institutions and other organizations. The standard replaces existing incurred loss impairment guidance and establishes a single allowance framework for financial assets carried at amortized cost. Upon adoption of ASU 2016-13, companies must recognize credit losses on these assets equal to management's estimate of credit losses over the full remaining expected life. Companies must consider all relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts. In December 2018, the Federal Reserve, OCC and FDIC released a final rule to revise their regulatory capital rules to address this upcoming change to the treatment of credit expense and allowances. The final rule provides an optional three-year phase-in period for the day-one adverse regulatory capital effects upon adopting the standard. The impact of this final rule on the Company will depend on whether we elect to phase in the impact of the standard over a three-year period. The standard may have a negative impact, potentially materially, to the allowance and capital at adoption in 2020; however, the Company is still evaluating the potential impact. It is also possible that the Company's ongoing reported earnings and lending activity will be negatively impacted in periods following adoption.

There is a Limited Public Market for the Company's Common Stock Which May Make It Difficult for Shareholders to Dispose of Their Shares

The Company's common stock is not listed on any exchange. However, trades may be reported on the OTC Markets under the symbol "FNRN". The Company is aware that D.A Davidson, Raymond James, Wedbush Morgan Securities, and Monroe Securities all currently make a market in the Company's common stock. Management is aware that there are also private transactions in the Company's common stock. However, the limited trading market for the Company's common stock may make it difficult for shareholders to dispose of their shares. Also, the price of the Company's common stock may be affected by general market price movements as well as developments specifically related to the financial services sector, including interest rate movements, quarterly variations, or changes in financial estimates by securities analysts and a significant reduction in the price of the stock of another participant in the financial services industry.

Advances and Changes in Technology, and the Company's Ability to Adapt Its Technology, could Impact Its Ability to Compete and Its Business and Operations

Advances and changes in technology can significantly impact the business and operations of the Company. The Company faces many challenges including the increased demand for providing computer access to Bank accounts and the systems to perform banking transactions electronically. The Company's merchant processing services require the use of advanced computer hardware and software technology and rapidly changing customer and regulatory requirements. The Company's ability to compete effectively depends on its ability to continue to adapt its technology on a timely and cost-effective basis to meet these requirements. In addition, the Company's business and operations are susceptible to negative impacts from computer system failures, communication and energy disruption, and unethical individuals with the technological ability to cause disruptions or failures of the Company's data processing systems.

Information Security Breaches or other technological difficulties could adversely affect the Company

Our operations rely on the secure processing, storage, transmission and reporting of personal, confidential and other sensitive information in our computer systems, networks and business applications. Although we take protective measures, our computer systems may be vulnerable to breaches, unauthorized access, misuse, computer viruses or other malicious code, and other events that could have significant negative consequences to us. Such events could result in interruptions or malfunctions in our or our customers' operations, interception, misuse or mishandling of personal or confidential information, or processing of unauthorized transactions or loss of funds. These events could result in litigation and financial losses that are either not insured against or not fully covered by our insurance, regulatory consequences or reputational harm, any of which could harm our competitive position, operating results and financial condition. These types of incidents can remain undetected for extended periods of time, thereby increasing the associated risks. We may also be required to expend significant resources to modify our protective measures or to investigate and remediate vulnerabilities or exposures arising from cybersecurity risks.

We depend on the continued efficacy of our technical systems, operational infrastructure, relationships with third parties and our employees in our day-to-day and ongoing operations. Our dependence upon automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. With regard to the physical infrastructure that supports our operations, we have taken measures to implement backup systems and other safeguards, but our ability to conduct business may be adversely affected by any disruption to that infrastructure. Failures in our internal control or operational systems, security breaches or service interruptions could impair our ability to operate our business and result in potential liability to customers, reputational damage and regulatory intervention, any of which could harm our operating results and financial condition.

We may also be subject to disruptions of our operating systems arising from other events that are wholly or partially beyond our control, such as electrical, internet or telecommunications outages or unexpected difficulties with the implementation of our technology enhancement projects, which may give rise to disruption of service to customers and to financial loss or liability. Our business recovery plan may not work as intended or may not prevent significant interruptions of our operations.

In recent years, it has been reported that several of the larger U.S. banking institutions have been the target of cyberattacks that have, for limited periods, resulted in the disruption of various operations of the targeted banks. While we have a variety of cyber-security measures in place, the consequences to our business, if we were to become a target of such attacks, cannot be predicted with any certainty.

In addition, there have been increasing efforts on the part of third parties to breach data security at financial institutions or with respect to financial transactions, including through the use of social engineering schemes such as "phishing." The ability of our customers to bank remotely, including online and through mobile devices, requires secure transmission of confidential information and increases the risk of data security breaches.

Under the applicable Federal regulatory guidance, financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes that enable recovery of data and business operations and that address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. While we do not believe that these statements contain any new regulatory expectations, they do indicate that the regulators regard cyber-security to be a matter of great importance for U.S. financial institutions. A financial institution which fails to observe the regulatory guidance could be subject to various regulatory sanctions, including financial sanctions.

In July of 2015, the Federal bank regulators announced the issuance of a cybersecurity assessment tool, the output of which can assist a financial institution's senior management and board of directors in assessing the institution's cybersecurity risk and preparedness. The first part of the assessment tool is the inherent risk profile, which aims to assist management in determining an institution's level of cybersecurity risk. The second part of the assessment tool is cybersecurity maturity, which is designed to help management assess whether their controls provide the desired level of preparedness. The Federal bank regulators plan to utilize the assessment tool as part of their examination process when evaluating financial institutions' cybersecurity preparedness in information technology and safety and soundness examinations and inspections. Failure to effectively utilize this tool would result in regulatory criticism. Management has conducted cybersecurity assessments using this tool and expects to perform additional periodic assessments to facilitate the identification and remediation of any concerns regarding our cyber-security preparedness.

Even if cyber-attacks and similar tactics are not directed specifically at the Bank, such attacks on other large financial institutions could disrupt the overall functioning of the financial system and undermine consumer confidence in banks generally, to the detriment of other financial institutions, including the Bank. A data security breach at a large U.S. retailer resulted in the compromise of data related to credit and debit cards of large numbers of customers requiring many banks, including the Bank, to reissue credit and debit cards for affected customers and reimburse these customers for losses sustained.

We maintain an insurance policy which we believe provides sufficient coverage at a manageable expense for an institution of our size and scope with similar technological systems. However, we cannot assure that this policy would be sufficient to cover all financial losses, damages, penalties, including lost revenues, should we experience any one or more of our or a third-party's systems failing or experiencing attack.

Environmental Hazards Could Have a Material Adverse Effect on the Company's Business, Financial Condition and Results of Operations

The Company, in its ordinary course of business, acquires real property securing loans that are in default, and there is a risk that hazardous substances or waste, contaminants or pollutants could exist on such properties. The Company may be required to remove or remediate such substances from the affected properties at its expense, and the cost of such removal or remediation may substantially exceed the value of the affected properties or the loans secured by such properties. Furthermore, the Company may not have adequate remedies against the prior owners or other responsible parties to recover its costs. Finally, the Company may find it difficult or impossible to sell the affected properties either prior to or following any such removal. In addition, the Company may be considered liable for environmental liabilities in connection with its borrowers' properties, if, among other things, it participates in the management of its borrowers' operations. The occurrence of such an event could have a material adverse effect on the Company's business, financial condition, results of operations and cash flows.

The Company may not be successful in raising additional capital needed in the future

If additional capital is needed in the future as a result of losses, our business strategy or regulatory requirements, there is no assurance that our efforts to raise such additional capital will be successful or that shares sold in the future will be sold at prices or on terms equal to or better than the current market price. The inability to raise additional capital when needed or at prices and terms acceptable to us could adversely affect our ability to implement our business strategies.

In the future the Company may be required to recognize impairment with respect to investment securities which may adversely affect our Results of Operations

The Company's securities portfolio currently includes securities with unrecognized losses. The Company may continue to observe declines in the fair market value of these securities. Management evaluates the securities portfolio for any other-than-temporary impairment each reporting period, as required by generally accepted accounting principles. There can be no assurance, however, that future evaluations of the securities portfolio will not require us to recognize impairment charges with respect to these and other holdings.

The Changes in the U.S. tax laws which generally became effective on January 1, 2018, will have both positive and negative effects on our business and results of operations.

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act ("TCJA") which made sweeping changes to the U.S. federal tax laws generally effective as of January 1, 2018. Certain of these changes will have positive effects on our business and results of operations and others will have negative effects. The TCJA reduces the corporate tax rate to 21 percent from 35 percent which resulted in a net reduction in our annual income tax expense and which should also benefit many of our corporate and other small business borrowers. However, our ability to utilize tax credits, such as those arising from low-income housing and alternative energy investments may be constrained by the lower tax rate.

ITEM 1B – UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 – PROPERTIES

The Company and the Bank are engaged in the banking business through fifteen offices in six counties in Northern California operating out of three offices in Solano County, six in Yolo County, two in Sacramento County, two in Placer County, one in Sonoma County and one in Contra Costa County. In addition, the Company owns four vacant lots, three in northern Solano County and one in eastern Sacramento County, for possible future bank sites.

The Bank owns three branch office locations and two administrative facilities and leases eleven facilities. Most of the leases contain multiple renewal options and provisions for rental increases, principally for changes in the cost of living index, property taxes and maintenance.

See Item 1 “Business - General” in this report for more information regarding our properties.

ITEM 3 - LEGAL PROCEEDINGS

Neither the Company nor the Bank is a party to any material pending legal proceeding, nor is any of its property the subject of any material pending legal proceeding, except ordinary routine litigation arising in the ordinary course of the Bank’s business and incidental to its business, none of which is expected to have a material adverse impact upon the Company’s or the Bank’s business, financial position or results of operations.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5 - MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is not listed on any exchange. However, trades may be reported on the OTC Markets under the symbol "FNRN". The Company is aware that D.A. Davidson, Raymond James, Wedbush Morgan Securities, and Monroe Securities, all currently make a market in the Company's common stock. Management is aware that there are also private transactions in the Company's common stock, and the data set forth below may not reflect all such transactions.

The following table summarizes the range of reported high and low bid quotations of the Company's Common Stock for each quarter during the last two fiscal years and is based on information provided by Stone & Youngberg. The quotations reflect the price that would be received by the seller without retail mark-up, mark-down or commissions and may not have represented actual transactions:

QUARTER/YEAR	HIGH*	LOW*
4th Quarter 2018	\$ 13.05	\$ 10.29
3rd Quarter 2018	\$ 13.14	\$ 13.00
2nd Quarter 2018	\$ 13.08	\$ 12.52
1st Quarter 2018	\$ 12.95	\$ 12.41
4th Quarter 2017	\$ 12.18	\$ 11.08
3rd Quarter 2017	\$ 11.12	\$ 10.90
2nd Quarter 2017	\$ 11.17	\$ 10.67
1st Quarter 2017	\$ 11.39	\$ 8.79

* Price adjusted for stock dividends in the indicated periods for the 5% stock dividends payable March 29, 2019 and March 29, 2018, as described below.

As of March 1, 2019, there were approximately 1,326 holders of record of the Company's common stock, no par value.

In the last two fiscal years the Company has declared the following stock dividends:

<u>Shareholder Record Date</u>	<u>Dividend Percentage</u>	<u>Date Payable</u>
February 28, 2017	4%	March 31, 2017
February 28, 2018	4%	March 29, 2018
February 28, 2019	5%	March 29, 2019

The Company does not expect to pay a cash dividend in the foreseeable future. Our ability to declare and pay dividends is affected by certain regulatory restrictions. See "Business – Restrictions on Dividends and Other Distributions" above. The Company made no repurchases of common stock in the twelve months ended December 31, 2018.

For information regarding securities authorized for issuance under equity compensation plans, see Part III, Item 12 of this report on Form 10-K.

ITEM 6 - SELECTED FINANCIAL DATA

The selected consolidated financial data below have been derived from the Company's audited consolidated financial statements. The selected consolidated financial data set forth below as of December 31, 2015, and 2014 have been derived from the Company's historical consolidated financial statements not included in this Report. The financial information for 2018, 2017, and 2016 should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," which is in Part II (Item 7) of this Report and with the Company's audited consolidated financial statements and the notes thereto, which are included in Part II (Item 8) of this Report.

Consolidated Financial Data as of and for the years ended December 31, (in thousands, except share and per share amounts)

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Interest and Dividend Income	\$ 45,617	\$ 40,017	\$ 35,967	\$ 31,440	\$ 29,585
Interest Expense	(1,268)	(1,079)	(1,157)	(1,154)	(1,291)
Net Interest Income	44,349	38,938	34,810	30,286	28,294
Provision for Loan Losses	(2,100)	(600)	(1,800)	(650)	(1,800)
Net Interest Income after Provision for Loan Losses	42,249	38,338	33,010	29,636	26,494
Non-Interest Income	7,209	8,128	7,278	7,596	7,480
Non-Interest Expense	(32,163)	(29,400)	(27,352)	(26,571)	(25,314)
Income before Taxes	17,295	17,066	12,936	10,661	8,660
Provision for Taxes	(4,744)	(8,318)	(4,885)	(3,740)	(2,790)
Net Income	<u>\$ 12,551</u>	<u>\$ 8,748</u>	<u>\$ 8,051</u>	<u>\$ 6,921</u>	<u>\$ 5,870</u>
Preferred Stock Dividend and Accretion	—	—	—	(105)	(129)
Net Income available to common shareholders	<u>\$ 12,551</u>	<u>\$ 8,748</u>	<u>\$ 8,051</u>	<u>\$ 6,816</u>	<u>\$ 5,741</u>
Basic Income Per Share	<u>\$ 1.04</u>	<u>\$ 0.72</u>	<u>\$ 0.67</u>	<u>\$ 0.58</u>	<u>\$ 0.49</u>
Diluted Income Per Share	<u>\$ 1.02</u>	<u>\$ 0.71</u>	<u>\$ 0.66</u>	<u>\$ 0.57</u>	<u>\$ 0.49</u>
Total Assets	<u>\$ 1,249,845</u>	<u>\$ 1,217,658</u>	<u>\$ 1,166,763</u>	<u>\$ 1,044,625</u>	<u>\$ 957,884</u>
Total Investments	<u>\$ 314,637</u>	<u>\$ 280,741</u>	<u>\$ 277,079</u>	<u>\$ 183,351</u>	<u>\$ 151,226</u>
Total Loans, including Loans Held-for-Sale, net	<u>\$ 765,688</u>	<u>\$ 740,152</u>	<u>\$ 673,096</u>	<u>\$ 606,204</u>	<u>\$ 538,470</u>
Total Deposits	<u>\$ 1,124,612</u>	<u>\$ 1,104,740</u>	<u>\$ 1,063,696</u>	<u>\$ 948,114</u>	<u>\$ 857,052</u>
Total Equity	<u>\$ 112,461</u>	<u>\$ 100,044</u>	<u>\$ 92,298</u>	<u>\$ 85,849</u>	<u>\$ 92,051</u>
Weighted Average Shares of Common Stock outstanding used for Basic Income Per Share Computation (1)	<u>12,123,801</u>	<u>12,082,983</u>	<u>12,058,728</u>	<u>12,026,852</u>	<u>11,983,037</u>
Weighted Average Shares of Common Stock outstanding used for Diluted Income Per Share Computation (1)	<u>12,291,695</u>	<u>12,236,517</u>	<u>12,136,282</u>	<u>12,093,316</u>	<u>12,045,343</u>
Return on Average Total Assets	1.03%	0.74%	0.74%	0.69%	0.62%
Net Income/Average Equity	12.00%	8.88%	8.87%	7.41%	6.59%
Net Income/Average Deposits	1.14%	0.82%	0.81%	0.76%	0.69%
Average Loans/Average Deposits	67.03%	63.40%	63.57%	62.18%	60.71%
Average Equity to Average Total Assets	8.58%	8.36%	8.31%	9.25%	9.46%

(1) All years have been restated to give retroactive effect for stock dividends issued and stock splits.

ITEM 7 – MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Introduction

This overview highlights selected information in this Annual Report on Form 10-K and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources, and critical accounting estimates, you should carefully read this entire Annual Report on Form 10-K.

Our subsidiary, First Northern Bank of Dixon, is a California state-chartered bank that derives most of its revenues from lending and deposit taking in the Sacramento Valley region of Northern California. Interest rates, business conditions and customer confidence all affect our ability to generate revenues. In addition, the regulatory environment and competition can challenge our ability to generate those revenues.

Financial highlights for 2018 include:

The Company reported net income of \$12.6 million for 2018, a 43.5% increase compared to net income of \$8.7 million for 2017. Net income per common share for 2018 was \$1.04, an increase of 44.4% compared to net income per common share of \$0.72 for 2017. Net income per common share on a fully diluted basis was \$1.02 for 2018, an increase of 43.7% compared to net income per common share on a fully diluted basis of \$0.71 for 2017.

Net interest income totaled \$44.3 million for 2018, an increase of 13.9% from \$38.9 million in 2017, primarily due to increased average loan volumes and rates, increased investment securities rates, increased rates on interest bearing due from banks, which was partially offset by decreased average investment securities volumes, decreased average due from banks and increased average interest-bearing transaction, savings and money market account volumes and rates.

The provision for loan losses in 2018 totaled \$2.1 million, an increase of 250.0% from \$0.6 million in 2017. Net charge-offs were \$411 thousand in 2018 compared to \$366 thousand in 2017. The increase in the provision for loan losses was primarily due to an increase in specific reserves on impaired loans, increases in classified and criticized loans as well as an overall increase in loan balances outstanding.

Non-interest income totaled \$7.2 million for 2018, a decrease of 11.3% from \$8.1 million in 2017. The decrease was primarily due to the 2017 gain on sale-leaseback transaction related to land and building which was partially occupied by a Bank branch. The total gain was \$1.7 million, of which \$0.5 million was deferred as a component of Other Liabilities and is being accounted for as a reduction of Occupancy and equipment expense over the initial lease term. The Company recognized \$82,000 and \$76,000 as a reduction of Occupancy and equipment expense for the years ended December 31, 2018 and 2017, respectively.

Non-interest expenses totaled \$32.2 million for 2018, up 9.4% from \$29.4 million in 2017. The increase was primarily due to increases in salaries and employee benefits due to increased staffing levels and data processing expenses as a result of core processing migration related costs and enhanced IT infrastructure.

The Company reported total assets of \$1.25 billion as of December 31, 2018, up 2.6% from \$1.22 billion as of December 31, 2017.

Investments increased to \$314.6 million as of December 31, 2018, a 12.1% increase from \$280.7 million as of December 31, 2017. U.S. Treasury securities totaled \$50.7 million as of December 31, 2018, up 174.5% from \$18.4 million as of December 31, 2017; securities of U.S. government agencies and corporations totaled \$42.1 million, up 99.3% from \$21.1 million as of December 31, 2017; obligations of state and political subdivisions totaled \$19.2 million, down 17.4% from \$23.2 million as of December 31, 2017; collateralized mortgage obligations totaled \$63.8 million, down 3.5% from \$66.1 million as of December 31, 2017; and mortgage-backed securities totaled \$138.9 million, down 8.5% from \$151.9 million as of December 31, 2017.

Loans (including loans held-for-sale), net of allowance, increased to \$765.7 million as of December 31, 2018, a 3.5% increase from \$740.2 million as of December 31, 2017. Commercial loans totaled \$125.2 million as of December 31, 2018, down 7.3% from \$135.0 million as of December 31, 2017; commercial real estate loans were \$420.1 million, up 5.5% from \$398.3 million as of December 31, 2017; agriculture loans were \$123.6 million, up 8.9% from \$113.6 million as of December 31, 2017; residential mortgage loans were \$51.1 million, up 21.3% from \$42.1 million as of December 31, 2017; residential construction loans were \$20.1 million, down 5.5% from \$21.3 million as of December 31, 2017; and consumer loans totaled \$35.4 million, down 9.0% from \$38.9 million as of December 31, 2017.

Deposits increased to \$1.12 billion as of December 31, 2018, a 1.8% increase from \$1.10 billion as of December 31, 2017.

Stockholders' equity increased to \$112.5 million as of December 31, 2018, an 12.4% increase from \$100.0 million as of December 31, 2017.

Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to the allowance for loan losses, other real estate owned, investments, and income taxes. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

Allowance for Loan Losses

The Company believes the allowance for loan losses accounting policy is critical because the loan portfolio represents the largest asset type on the consolidated balance sheet, and there is significant judgment used in determining the adequacy of the allowance for loan losses. The Company maintains an allowance for loan losses resulting from the inability of borrowers to make required loan payments. Loan losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan losses is based on the Company's periodic evaluation of the factors mentioned below, as well as other pertinent factors. The allowance for loan losses consists of an allocated component and a general component. The components of the allowance for loan losses represent an estimate. The allocated component of the allowance for loan losses reflects expected losses resulting from analyses developed through specific credit allocations for individual loans and historical loss experience for each loan category. The specific credit allocations are based on regular analyses of all loans where the internal credit rating is at or below a predetermined classification. These analyses involve a high degree of judgment in estimating the amount of loss associated with specific loans, including estimating the amount and timing of future cash flows and collateral values. The historical loan loss element is determined using analysis that examines loss experience.

The allocated component of the allowance for loan losses also includes consideration of concentrations and changes in portfolio mix and volume. The general portion of the allowance reflects the Company's estimate of probable inherent but undetected losses within the portfolio due to uncertainties in economic conditions, delays in obtaining information, including unfavorable information about a borrower's financial condition, the difficulty in identifying triggering events that correlate perfectly to subsequent loss rates, and risk factors that have not yet manifested themselves in loss allocation factors. Uncertainty surrounding the strength and timing of economic cycles also affects estimates of loss. There are many factors affecting the allowance for loan losses; some are quantitative while others require qualitative judgment. Although the Company believes its process for determining the allowance adequately considers all of the potential factors that could potentially result in credit losses, the process includes subjective elements and may be susceptible to significant change. To the extent actual outcomes differ from Company estimates, additional provision for credit losses could be required that could adversely affect earnings or financial position in future periods.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. For a loan that has been restructured, the contractual terms of the loan agreement refer to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. An impaired loan is measured based upon the present value of future cash flows discounted at the loan's effective rate, the loan's observable market price, or the fair value of collateral if the loan is collateral dependent. If the measurement of the impaired loan is less than the recorded investment in the loan, an impairment is recognized by a charge to the allowance for loan losses.

Other-than-temporary Impairment in Debt Securities

Debt securities with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate debt securities, from rising interest rates. At each consolidated financial statement date, management assesses each debt security to determine if impaired debt securities are temporarily impaired or if the impairment is other than temporary. This assessment includes consideration regarding the duration and severity of impairment, the credit quality of the issuer and a determination of whether the Company intends to sell the security, or if it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. Other-than-temporary impairment is recognized in earnings if one of the following conditions exists: 1) the Company's intent is to sell the security; 2) it is more likely than not that the Company will be required to sell the security before the impairment is recovered; or 3) the Company does not expect to recover its amortized cost basis. If, by contrast, the Company does not intend to sell the security and will not be required to sell the security prior to recovery of the amortized cost basis, the Company recognizes only the credit loss component of other-than-temporary impairment in earnings. The credit loss component is calculated as the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of the future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income.

Fair Value Measurements

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a non-recurring basis, such as loans held-for-sale, loans held-for-investment and certain other assets. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally corresponds with the Company's quarterly valuation process. For additional discussion, see Note 12 to the Consolidated Financial Statements in this Form 10-K.

Share-Based Payment

The Company determines the fair value of stock options at grant date using the Black-Scholes-Merton pricing model that takes into account the stock price at the grant date, the exercise price, the expected dividend yield, stock price volatility, and the risk-free interest rate over the expected life of the option. The Black-Scholes-Merton model requires the input of highly subjective assumptions including the expected life of the stock-based award and stock price volatility. The estimates used in the model involve inherent uncertainties and the application of Management's judgment. As a result, if other assumptions had been used, our recorded stock-based compensation expense could have been materially different from that reflected in these financial statements. The fair value of non-vested restricted common shares generally equals the stock price at grant date. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those share-based awards expected to vest. If our actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different. For additional discussion, see Note 14 to the Consolidated Financial Statements in this Form 10-K.

Accounting for Income Taxes

Income taxes reported in the consolidated financial statements are computed based on an asset and liability approach. We recognize the amount of taxes payable or refundable for the current year, and deferred tax assets and liabilities for the expected future tax consequences that have been recognized in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We record net deferred tax assets to the extent it is more-likely-than-not that they will be realized. In evaluating our ability to recover the deferred tax assets, Management considers all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial operations. In projecting future taxable income, Management develops assumptions including the amount of future state and federal pretax operating income, the reversal of temporary differences, and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates being used to manage the underlying business. The Company files consolidated federal and combined state income tax returns.

A "more-likely-than-not" recognition threshold must be met before a tax benefit can be recognized in the financial statements. For tax positions that meet the more-likely-than-not threshold, an enterprise may recognize only the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with the taxing authority. To the extent tax authorities disagree with these tax positions, our effective tax rates could be materially affected in the period of settlement with the taxing authorities. For additional discussion, see Note 17 to the Consolidated Financial Statements in this Form 10-K.

Mortgage Servicing Rights

Transfers and servicing of financial assets and extinguishments of liabilities are accounted for and reported based on consistent application of a financial-components approach that focuses on control. Transfers of financial assets that are sales are distinguished from transfers that are secured borrowings. Retained interests (mortgage servicing rights) in loans sold are measured by allocating the previous carrying amount of the transferred assets between the loans sold and retained interest, if any, based on their relative fair value at the date of transfer. Fair values are estimated using discounted cash flows based on a current market interest rate. The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold.

The recorded value of mortgage servicing rights is included in other assets on the Consolidated Balance Sheets initially at fair value, and is amortized in proportion to, and over the period of, estimated net servicing revenues. The Company assesses capitalized mortgage servicing rights for impairment based upon the fair value of those rights at each reporting date. For purposes of measuring impairment, the rights are stratified based upon the product type, term and interest rates. Fair value is determined by discounting estimated net future cash flows from mortgage servicing activities using discount rates that approximate current market rates and estimated prepayment rates, among other assumptions. The amount of impairment recognized, if any, is the amount by which the capitalized mortgage servicing rights for a stratum exceeds their fair value. Impairment, if any, is recognized through a valuation allowance for each individual stratum.

Impact of Recently Issued Accounting Standards

In February 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-02, *Leases (Topic 842)*. The amendments in ASU 2016-02, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

- A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
- A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

In July 2018, FASB issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. These amendments provide entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases). The amendments also provide lessors with a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue guidance (Topic 606) and certain criteria are met. For entities that have not adopted Topic 842 before the issuance of ASU 2018-11, the effective date and transition requirements for the amendments related to separating components of a contract are the same as the effective date and transition requirements in ASU 2016-02. The Company applied this optional transition method upon adoption of ASU 2016-02 on January 1, 2019.

The amendments in these ASU's are effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company adopted ASU 2016-02 on January 1, 2019. As a result, the Company recognized a lease liability and right-of-use asset of approximately \$4.8 million and \$4.4 million, which were recognized in other liabilities and other assets, respectively.

In June 2016, FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in ASU 2016-13, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments are effective for public companies for annual periods beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the potential impact of ASU 2016-13 on our financial statements. In that regard, we have formed a cross-functional working group, under the direction of our Chief Financial Officer and our Chief Credit Officer. The working group is comprised of individuals from various functional areas including credit risk, finance and information technology, among others. We are currently working through our implementation plan which includes assessment and documentation of processes, internal controls and data sources; model development and documentation; and system configuration, among other things. We are also in the process of implementing a third-party vendor solution to assist us in the application of the ASU 2016-13. The adoption of the ASU 2016-13 could result in an increase in the allowance for loan losses as a result of changing from an "incurred loss" model, which encompasses allowances for current known and inherent losses within the portfolio, to an "expected loss" model, which encompasses allowances for losses expected to be incurred over the life of the portfolio. Furthermore, ASU 2016-13 will necessitate that we establish an allowance for expected credit losses for certain debt securities and other financial assets. While we are currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption will be significantly influenced by the composition, characteristics and quality of our loan and securities portfolios as well as the prevailing economic conditions and forecasts as of the adoption date.

In August 2018, FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. These amendments modify various disclosure requirements in Topic 820. For all entities, amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In August 2018, FASB issued ASU 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*. These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. For public business entities, amendments are effective for fiscal years ending after December 15, 2020. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In August 2018, FASB issued ASU 2018-15, *Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*. ASU 2018-15 clarifies certain aspects of ASU 2015-05, "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement," which was issued in April 2015. Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 does not affect the accounting for the service element of a hosting arrangement that is a service contract. ASU 2018-15 will be effective for the Company on January 1, 2020, with early adoption permitted, and is not expected to have a significant impact on its financial statements.

In November 2018, FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*. The guidance clarifies that receivables arising from operating leases are not within the scope of the credit losses standard, but rather should be accounted for in accordance with the leases standard. The effective date and transition requirements are the same as the effective dates and transition requirements in the credit losses standard, ASU 2016-13. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

STATISTICAL INFORMATION AND DISCUSSION

The following statistical information and discussion should be read in conjunction with the Selected Financial Data included in Part II (Item 6) and the audited consolidated financial statements and accompanying notes included in Part II (Item 8) of this Annual Report on Form 10-K.

The following tables present information regarding the consolidated average assets, liabilities and stockholders' equity, the amounts of interest income from average earning assets and the resulting yields, and the amount of interest expense paid on interest-bearing liabilities. Average loan balances include non-performing loans. Interest income includes proceeds from loans on non-accrual status only to the extent cash payments have been received and applied as interest income. Tax-exempt income is not shown on a tax equivalent basis.

Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential (Dollars in thousands)

	2018		2017		2016	
	Average Balance	Percent	Average Balance	Percent	Average Balance	Percent
ASSETS						
Cash and Due From Banks	\$ 139,957	11.5%	\$ 156,638	13.3%	\$ 169,823	15.5%
Certificates of Deposit	4,160	0.3%	6,923	0.6%	16,615	1.5%
Investment Securities	293,259	24.1%	296,924	25.2%	237,127	21.7%
Loans (1)	739,243	60.6%	677,522	57.5%	631,181	57.8%
Stock in Federal Home Loan Bank and other equity securities, at cost	5,884	0.5%	5,218	0.4%	4,263	0.4%
Other Real Estate Owned	185	0.0%	—	—	7	0.0%
Other Assets	36,460	3.0%	34,759	3.0%	33,958	3.1%
Total Assets	\$ 1,219,148	100.0%	\$ 1,177,984	100.0%	\$ 1,092,974	100.0%
LIABILITIES & STOCKHOLDERS' EQUITY						
Deposits:						
Demand	\$ 394,106	32.3%	\$ 361,729	30.7%	\$ 329,933	30.2%
Interest-Bearing Transaction Deposits	307,727	25.2%	293,464	24.9%	269,197	24.6%
Savings & MMDAs	333,788	27.4%	335,709	28.5%	309,638	28.3%
Time Certificates	67,177	5.5%	77,705	6.6%	84,087	7.7%
Borrowed Funds	—	0.0%	—	0.0%	—	0.0%
Other Liabilities	11,743	1.0%	10,860	0.9%	9,309	0.9%
Stockholders' Equity	104,607	8.6%	98,517	8.4%	90,810	8.3%
Total Liabilities & Stockholders' Equity	\$ 1,219,148	100.0%	\$ 1,177,984	100.0%	\$ 1,092,974	100.0%

(1) Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses.

Net Interest Earnings
Average Balances, Yields and Rates
(Dollars in thousands)

Assets	2018			2017			2016		
	Average Balance	Interest Income/Expense	Yields Earned/Rates Paid	Average Balance	Interest Income/Expense	Yields Earned/Rates Paid	Average Balance	Interest Income/Expense	Yields Earned/Rates Paid
Total Loans, Including Loan Fees (1)	\$ 739,243	\$ 37,189	5.03%	\$ 677,522	\$ 33,115	4.89%	\$ 631,181	\$ 30,697	4.86%
Due From Banks	114,350	2,163	1.89%	131,478	1,428	1.09%	144,996	746	0.51%
Certificates of Deposit	4,160	104	2.50%	6,923	72	1.04%	16,615	145	0.87%
Investment Securities:									
Taxable	283,500	5,500	1.94%	279,711	4,762	1.70%	223,011	3,582	1.61%
Non-taxable (2)	9,759	143	1.47%	17,213	257	1.49%	14,116	276	1.96%
Total Investment Securities	293,259	5,643	1.92%	296,924	5,019	1.69%	237,127	3,858	1.63%
Other Earning Assets	5,884	518	8.80%	5,218	383	7.34%	4,263	521	12.22%
Total Earning Assets	\$ 1,156,896	\$ 45,617	3.94%	\$ 1,118,065	\$ 40,017	3.58%	\$ 1,034,182	\$ 35,967	3.48%
Cash and Due from Banks	25,607			25,160			24,827		
Other Real Estate Owned	185			—			7		
Interest Receivable and Other Assets	36,460			34,759			33,958		
Total Assets	\$ 1,219,148			\$ 1,177,984			\$ 1,092,974		

(1) Average balances for loans include loans held-for-sale and non-accrual loans and are net of the allowance for loan losses, but non-accrued interest thereon is excluded. Includes amortization of deferred loan fees and costs.

(2) Interest income and yields on tax-exempt securities are not presented on a taxable equivalent basis.

**Continuation of
Net Interest Earnings
Average Balances, Yields and Rates**
(Dollars in thousands)

Liabilities and Stockholders' Equity	2018			2017			2016		
	Average Balance	Interest Income/ Expense	Yields Earned/ Rates Paid	Average Balance	Interest Income/ Expense	Yields Earned/ Rates Paid	Average Balance	Interest Income/ Expense	Yields Earned/ Rates Paid
Interest-Bearing Deposits:									
Interest-Bearing Transaction Deposits	\$ 307,727	\$ 428	0.14%	\$ 293,464	\$ 246	0.08%	\$ 269,197	\$ 309	0.11%
Savings & MMDAs	333,788	559	0.17%	335,709	530	0.16%	309,638	511	0.17%
Time Certificates	67,177	281	0.42%	77,705	303	0.39%	84,087	337	0.40%
Total Interest-Bearing Deposits	708,692	1,268	0.18%	706,878	1,079	0.15%	662,922	1,157	0.17%
Demand Deposits	394,106			361,729			329,933		
Total Deposits	1,102,798	\$ 1,268	0.11%	1,068,607	\$ 1,079	0.10%	992,855	\$ 1,157	0.12%
Interest payable and Other Liabilities	11,743			10,860			9,309		
Stockholders' Equity	104,607			98,517			90,810		
Total Liabilities and Stockholders' Equity	\$ 1,219,148			\$ 1,177,984			\$ 1,092,974		
Net Interest Income and Net Interest Margin (1)		\$ 44,349	3.83%		\$ 38,938	3.48%		\$ 34,810	3.37%
Net Interest Spread (2)			3.76%			3.43%			3.31%

(1) Net interest margin is computed by dividing net interest income by total average interest-earning assets.

(2) Net interest spread represents the average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

**Analysis of Changes
in Interest Income and Interest Expense**
(Dollars in thousands)

Following is an analysis of changes in interest income and expense (dollars in thousands) for 2018 over 2017 and 2017 over 2016. Changes not solely due to interest rate or volume have been allocated proportionately to interest rate and volume.

	2018 Over 2017			2017 Over 2016		
	Volume	Interest Rate	Change	Volume	Interest Rate	Change
Increase (Decrease) in Interest Income:						
Loans	\$ 3,099	\$ 975	\$ 4,074	\$ 2,481	\$ (63)	\$ 2,418
Due From Banks	(207)	942	735	(76)	758	682
Certificates of Deposit	(38)	70	32	(97)	24	(73)
Investment Securities - Taxable	64	674	738	967	213	1,180
Investment Securities - Non-taxable	(111)	(3)	(114)	54	(73)	(19)
Other Earning Assets	53	82	135	100	(238)	(138)
	\$ 2,860	\$ 2,740	\$ 5,600	\$ 3,429	\$ 621	\$ 4,050
Increase (Decrease) in Interest Expense:						
Deposits:						
Interest-Bearing Transaction Deposits	\$ 11	\$ 171	\$ 182	\$ 25	\$ (88)	\$ (63)
Savings & MMDAs	(3)	32	29	48	(29)	19
Time Certificates	(44)	22	(22)	(26)	(8)	(34)
Borrowed Funds	—	—	—	—	—	—
	\$ (36)	\$ 225	\$ 189	\$ 47	\$ (125)	\$ (78)
Increase in Net Interest Income:	\$ 2,896	\$ 2,515	\$ 5,411	\$ 3,382	\$ 746	\$ 4,128

INVESTMENT PORTFOLIO

Composition of Investment Securities

The mix of investment securities held by the Company at December 31, of the previous three fiscal years is as follows (dollars in thousands):

	2018	2017	2016
Investment securities available-for-sale (at fair value):			
U.S. Treasury Securities	\$ 50,682	\$ 18,464	\$ 28,652
Securities of U.S. Government Agencies and Corporations	42,076	21,109	24,197
Obligations of State & Political Subdivisions	19,168	23,208	30,888
Collateralized Mortgage Obligations	63,799	66,083	49,938
Mortgage-Backed Securities	138,912	151,877	143,404
Total Investments	\$ 314,637	\$ 280,741	\$ 277,079

Maturities of Investment Securities

The following table is a summary of the relative maturities (dollars in thousands) and projected yields of the Company's investment securities as of December 31, 2018. The yields on tax-exempt securities are shown on a tax equivalent basis.

	<u>Period to Maturity</u>					
	<u>Within One Year</u>		<u>After One But Within Five Years</u>		<u>After Five But Within Ten Years</u>	
	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>
Investment securities available-for-sale (at fair value):						
U.S. Treasury Securities	\$ 21,404	1.92%	\$ 29,278	2.49%	\$ —	—
Securities of U.S. Government Agencies and Corporations	23,131	1.90%	18,945	2.37%	—	—
Obligations of State & Political Subdivisions	2,579	2.11%	10,425	2.21%	5,628	4.12%
Collateralized Mortgage Obligations	—	—	62,743	2.08%	1,056	2.86%
Mortgage-Backed Securities	1,231	2.34%	135,913	2.01%	1,768	2.73%
TOTAL	\$ 48,345	1.93%	\$ 257,304	2.12%	\$ 8,452	3.67%
			<u>After Ten Years</u>		<u>Total</u>	
			<u>Amount</u>	<u>Yield</u>	<u>Amount</u>	<u>Yield</u>
Investment securities available-for-sale (at fair value):						
U.S. Treasury Securities			\$ —	—	\$ 50,682	2.25%
Securities of U.S. Government Agencies and Corporations			—	—	42,076	2.11%
Obligations of State & Political Subdivisions			536	3.90%	19,168	2.81%
Collateralized Mortgage Obligations			—	—	63,799	2.09%
Mortgage-Backed Securities			—	—	138,912	2.02%
TOTAL			\$ 536	3.90%	\$ 314,637	2.13%

LOAN PORTFOLIO

Composition of Loans

The mix of loans, net of deferred origination fees and costs and allowance for loan losses and excluding loans held-for-sale, at December 31, for the previous five fiscal years is as follows (dollars in thousands):

	December 31,					
	2018		2017		2016	
	Balance	Percent	Balance	Percent	Balance	Percent
Commercial	\$ 125,177	16.1%	\$ 135,015	18.0%	\$ 126,311	18.6%
Commercial Real Estate	420,106	54.2%	398,346	53.2%	344,210	50.6%
Agriculture	123,626	15.9%	113,555	15.2%	101,905	15.0%
Residential Mortgage	51,064	6.6%	42,081	5.6%	40,237	5.9%
Residential Construction	20,124	2.6%	21,299	2.8%	23,650	3.5%
Consumer	35,397	4.6%	38,900	5.2%	43,250	6.4%
	<u>775,494</u>	<u>100.0%</u>	<u>749,196</u>	<u>100.0%</u>	<u>679,563</u>	<u>100.0%</u>
Allowance for loan losses	(12,822)		(11,133)		(10,899)	
Net deferred origination fees and costs	721		1,049		1,106	
TOTAL	<u>\$ 763,393</u>		<u>\$ 739,112</u>		<u>\$ 669,770</u>	

	December 31,			
	2015		2014	
	Balance	Percent	Balance	Percent
Commercial	\$ 136,095	22.2%	\$ 120,751	22.1%
Commercial Real Estate	292,316	47.6%	256,955	47.1%
Agriculture	84,813	13.8%	61,144	11.2%
Residential Mortgage	43,375	7.0%	50,511	9.3%
Residential Construction	12,110	2.0%	5,963	1.1%
Consumer	45,386	7.4%	49,911	9.2%
	<u>614,095</u>	<u>100.0%</u>	<u>545,235</u>	<u>100.0%</u>
Allowance for loan losses	(9,251)		(8,583)	
Net deferred origination fees and costs	1,009		1,327	
TOTAL	<u>\$ 605,853</u>		<u>\$ 537,979</u>	

Commercial loans are primarily for financing the needs of a diverse group of businesses located in the Bank's market area. Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Real estate construction loans are generally for financing the construction of single-family residential homes for individuals and builders we believe are well-qualified. These loans are secured by real estate and have short maturities. Residential mortgage loans, which are secured by real estate, include owner-occupied and non-owner occupied properties in the Bank's market area. Loans are considered agriculture loans when the primary source of repayment is from the sale of an agricultural or agricultural-related product or service. Such loans are secured and/or unsecured to producers and processors of crops and livestock. The Bank also makes loans to individuals for investment purposes.

As shown in the comparative figures for loan mix during 2018 and 2017, total loans increased as a result of increases in commercial real estate loans, agriculture loans and residential mortgage loans, which were partially offset by decreases in commercial loans, residential construction loans and consumer loans.

Maturities and Sensitivities of Loans to Changes in Interest Rates

Loan maturities of the loan portfolio at December 31, 2018 are as follows (dollars in thousands) (exclude s loans held-for-sale):

Maturing	Fixed Rate	Variable Rate	Total
Within one year	\$ 14,362	\$ 100,566	\$ 114,928
After one year through five years	96,434	32,679	129,113
After five years	101,534	429,919	531,453
Total	\$ 212,330	\$ 563,164	\$ 775,494

Non-accrual, Past Due, OREO and Restructured Loans

It is generally the Company's policy to discontinue interest accruals once a loan is past due for a period of 90 days as to interest or principal payments. When a loan is placed on non-accrual, interest accruals cease and uncollected accrued interest is reversed and charged against current income. Payments received on non-accrual loans are applied against principal. A loan may only be restored to an accruing basis when it again becomes well secured and in the process of collection or all past due amounts have been collected and an appropriate period of performance has been demonstrated.

The following tables summarize the Company's non-accrual loans by loan category (dollars in thousands), net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies at December 31, 2018, 2017, 2016, 2015, and 2014.

	At December 31, 2018			At December 31, 2017		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
Commercial	\$ 750	\$ 300	\$ 450	\$ 1,057	\$ 32	\$ 1,025
Commercial real estate	381	56	325	1,724	70	1,654
Agriculture	4,830	776	4,054	—	—	—
Residential mortgage	100	—	100	781	—	781
Residential construction	—	—	—	—	—	—
Consumer	191	—	191	205	—	205
Total non-accrual loans	\$ 6,252	\$ 1,132	\$ 5,120	\$ 3,767	\$ 102	\$ 3,665

	At December 31, 2016			At December 31, 2015		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
Commercial	\$ 5,000	\$ 2,000	\$ 3,000	\$ 112	\$ 57	\$ 55
Commercial real estate	540	81	459	964	95	869
Agriculture	—	—	—	—	—	—
Residential mortgage	654	—	654	1,092	—	1,092
Residential construction	—	—	—	—	—	—
Consumer	103	—	103	560	—	560
Total non-accrual loans	\$ 6,297	\$ 2,081	\$ 4,216	\$ 2,728	\$ 152	\$ 2,576

	At December 31, 2014		
	Gross	Guaranteed	Net
Commercial	\$ 2,151	\$ 82	\$ 2,069
Commercial real estate	672	—	672
Agriculture	—	—	—
Residential mortgage	1,691	—	1,691
Residential construction	71	—	71
Consumer	652	—	652
Total non-accrual loans	<u>\$ 5,237</u>	<u>\$ 82</u>	<u>\$ 5,155</u>

Non-accrual loans amounted to \$6,252,000 at December 31, 2018 and were comprised of two commercial loans totaling \$750,000, two commercial real estate loans totaling \$381,000, five agriculture loans totaling \$4,830,000, two residential mortgage loans totaling \$100,000, and one consumer loan totaling \$191,000.

Non-accrual loans amounted to \$3,767,000 at December 31, 2017 and were comprised of three commercial loans totaling \$1,057,000, three commercial real estate loans totaling \$1,724,000, three residential mortgage loans totaling \$781,000, and one consumer loan totaling \$205,000. Non-accrual loans amounted to \$6,297,000 at December 31, 2016 and were comprised of three residential mortgage loans totaling \$654,000, two commercial real estate loans totaling \$540,000, one commercial loan totaling \$5,000,000, and one consumer loan totaling \$103,000.

If interest on non-accrual loans had been accrued, such interest income would have approximated \$377,000, \$158,000 and \$270,000 during the years ended December 31, 2018, 2017, and 2016, respectively. Income actually recognized for these loans approximated \$23,000, \$50,000 and \$38,000 for the years ended December 31, 2018, 2017, and 2016, respectively.

Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Non-performing impaired loans are non-accrual loans and loans that are 90 days or more past due and still accruing. Total non-performing impaired loans at December 31, 2018, 2017, and 2016 consisting of loans on non-accrual status totaled \$6,252,000, \$3,767,000 and \$6,297,000, respectively. A restructuring of a loan can constitute a troubled debt restructuring if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A loan that is restructured in a troubled debt restructuring is considered an impaired loan. Performing impaired loans, which consisted of loans modified as troubled debt restructurings, totaled \$4,622,000, \$5,234,000 and \$4,662,000 at December 31, 2018, 2017, and 2016, respectively. The Company expects to collect all principal and interest due from performing impaired loans. These loans are not on non-accrual status. No assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

The Company had no loans 90 days past due and still accruing as of December 31, 2018. The Company had one loan totaling \$45,000 that was 90 days past due and still accruing at December 31, 2017. The Company had no loans 90 days past due and still accruing as of December 31, 2016.

As the following table illustrates, total non-performing assets, which consists of loans on non-accrual status, loans past due 90-days and still accruing and Other Real Estate Owned ("OREO") net of guarantees of the State of California and U.S. Government, including its agencies and its government-sponsored agencies, increased \$2,502,000, or 67.4%, to \$6,212,000 from December 31, 2017 and decreased \$506,000 or 12.0%, at December 31, 2017 from December 31, 2016. Non-performing assets net of guarantees represent 0.5%, 0.3% and 0.4% of total assets at December 31, 2018, 2017, and 2016, respectively. The Bank's management believes that the \$6,252,000 in non-accrual loans were appropriately reflected at their fair value at December 31, 2018. However, no assurance can be given that the existing or any additional collateral will be sufficient to secure full recovery of the obligations owed under these loans.

	At December 31, 2018			At December 31, 2017		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
(dollars in thousands)						
Non-accrual loans	\$ 6,252	\$ 1,132	\$ 5,120	\$ 3,767	\$ 102	\$ 3,665
Loans 90 days past due and still accruing	—	—	—	45	—	45
Total non-performing loans	6,252	1,132	5,120	3,812	102	3,710
Other real estate owned	1,092	—	1,092	—	—	—
Total non-performing assets	7,344	1,132	6,212	3,812	102	3,710
Non-performing loans (net of guarantees) to total loans			0.7%			0.5%
Non-performing assets (net of guarantees) to total assets			0.5%			0.3%
Allowance for loan and lease losses to non-performing loans (net of guarantees)			250.4%			300.1%
	At December 31, 2016			At December 31, 2015		
	Gross	Guaranteed	Net	Gross	Guaranteed	Net
(dollars in thousands)						
Non-accrual loans	\$ 6,297	\$ 2,081	\$ 4,216	\$ 2,728	\$ 152	\$ 2,576
Loans 90 days past due and still accruing	—	—	—	2	—	2
Total non-performing loans	6,297	2,081	4,216	2,730	152	2,578
Other real estate owned	—	—	—	—	—	—
Total non-performing assets	6,297	2,081	4,216	2,730	152	2,578
Non-performing loans (net of guarantees) to total loans			0.6%			0.4%
Non-performing assets (net of guarantees) to total assets			0.4%			0.3%
Allowance for loan and lease losses to non-performing loans (net of guarantees)			258.5%			358.8%
	At December 31, 2014					
	Gross	Guaranteed	Net			
(dollars in thousands)						
Non-accrual loans	\$ 5,237	\$ 82	\$ 5,155			
Loans 90 days past due and still accruing	—	—	—			
Total non-performing loans	5,237	82	5,155			
Other real estate owned	736	—	736			
Total non-performing assets	5,973	82	5,891			
Non-performing loans (net of guarantees) to total loans			0.9%			
Non-performing assets (net of guarantees) to total assets			0.6%			
Allowance for loan and lease losses to non-performing loans (net of guarantees)			166.5%			

OREO consists of property that the Company has acquired by deed in lieu of foreclosure or through foreclosure proceedings, and property that the Company does not hold title to but is in actual control of, known as in-substance foreclosure. The estimated fair value of the property is determined prior to transferring the balance to OREO. The balance transferred to OREO is the estimated fair value of the property less estimated cost to sell. Impairment may be deemed necessary to bring the book value of the loan equal to the appraised value. Appraisals or loan officer evaluations are then conducted periodically thereafter charging any additional impairment to the appropriate expense account. The Company had one commercial real estate property classified as OREO totaling \$1,092,000 as of the period ended December 31, 2018. The Company had no OREO as of the periods ended December 31, 2017 and 2016.

Potential Problem Loans

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies. The federal banking regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes: "Substandard Assets: a substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected." "Doubtful Assets: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable." Other Real Estate Owned" and loans rated Substandard and Doubtful are deemed "classified assets". This category, which includes both performing and non-performing assets, receives an elevated level of attention regarding collection.

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and other real property of the business and are susceptible to the related risks described above. Problem commercial loans are generally identified by periodic review of financial information that may include financial statements, tax returns, and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to commercial loans whether secured by equipment, receivables or other personal property or unsecured. Problem commercial real estate loans are generally identified by periodic review of financial information that may include financial statements, tax returns, payment history of the borrower, and site inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Losses on loans secured by owner-occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resultant over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as changing weather conditions. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Residential mortgage loans, which are secured by real estate, are primarily susceptible to three risks; non-payment due to diminished or lost income, over-extension of credit, a lack of borrower's cash flow to sustain payments, and shortfalls in collateral value. In general, non-payment is due to loss of employment and follows general economic trends in the marketplace, particularly the upward movement in the unemployment rate, loss of collateral value, and demand shifts. Problem residential mortgage loans are generally identified via payment default. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Construction loans, whether owner occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction itself, including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Again, losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, or repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Consumer loans, whether unsecured or secured, are primarily susceptible to four risks: non-payment due to diminished or lost income, over-extension of credit, a lack of borrower's cash flow to sustain payments, and shortfall in collateral value. In general, non-payment is due to loss of employment and will follow general economic trends in the marketplace, particularly the upward movements in the unemployment rate, loss of collateral value, and demand shifts. Problem consumer loans are generally identified via payment default. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Appropriate valuations are obtained at origination of the credit and periodically thereafter (generally every 3-12 months depending on the collateral type and market conditions), once repayment is questionable, and the loan has been deemed classified.

Once a loan becomes delinquent or repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment of principal and interest in accordance with the contractual terms of the loan agreement becomes unlikely, the Company will consider the loan to be impaired and will estimate its probable loss, using the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. For collateral dependent loans, the Company will utilize a recent valuation of the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final collection, the Company may periodically revalue the estimated loss and take additional charge-offs or specific reserves as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when the collateral is liquidated and the actual loss is confirmed. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

Excluding the non-performing loans cited previously, loans totaling \$15,926,000 and \$2,045,000 were classified as substandard or doubtful loans, representing potential problem loans at December 31, 2018 and 2017, respectively. In Management's opinion, the potential loss related to these problem loans was sufficiently covered by the Bank's existing loan loss reserve (Allowance for Loan Losses) at December 31, 2018 and 2017. The ratio of the Allowance for Loan Losses to total loans at December 31, 2018 and 2017 was 1.65% and 1.49%, respectively.

SUMMARY OF LOAN LOSS EXPERIENCE

The Company's allowance for credit losses is maintained at a level considered adequate to provide for losses that can be estimated based upon specific and general conditions. These include conditions unique to individual borrowers, as well as overall credit loss experience, the amount of past due, non-performing loans and classified loans, recommendations of regulatory authorities, prevailing economic conditions and other factors. A portion of the allowance is specifically allocated to classified loans whose full collectability is uncertain. Such allocations are determined by Management based on loan-by-loan analyses. In addition, loans with similar characteristics not usually criticized using regulatory guidelines are analyzed based on the historical loss rates and delinquency trends, grouped by the number of days the payments on these loans are delinquent. Last, allocations are made to non-criticized and classified commercial loans and residential real estate loans based on historical loss rates, and other statistical data. The remainder of the allowance is considered to be unallocated. The unallocated allowance is established to provide for probable losses that have been incurred as of the reporting date but not reflected in the allocated allowance. It addresses additional qualitative factors consistent with Management's analysis of the level of risks inherent in the loan portfolio, which are related to the risks of the Company's general lending activity. Included in the unallocated allowance is the risk of losses that are attributable to national or local economic or industry trends which have occurred but have yet been recognized in past loan charge-off history (external factors). The external factors evaluated by the Company include: economic and business conditions, external competitive issues, and other factors. Also included in the unallocated allowance is the risk of losses attributable to general attributes of the Company's loan portfolio and credit administration (internal factors). The internal factors evaluated by the Company include: loan review system, adequacy of lending Management and staff, loan policies and procedures, problem loan trends, concentrations of credit, and other factors. By their nature, these risks are not readily allocable to any specific loan category in a statistically meaningful manner and are difficult to quantify. Management assigns a range of estimated risk to the qualitative risk factors described above based on Management's judgment as to the level of risk and assigns a quantitative risk factor from the range of loss estimates to determine the appropriate level of the unallocated portion of the allowance. Management considered the \$12,822,000 allowance for credit losses to be adequate as a reserve against losses as of December 31, 2018.

Analysis of the Allowance for Loan Losses
(Dollars in thousands)

	<u>2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Balance at Beginning of Year	\$ 11,133	\$ 10,899	\$ 9,251	\$ 8,583	\$ 9,353
Provision for Loan Losses	2,100	600	1,800	650	1,800
Loans Charged-Off:					
Commercial	(509)	(681)	(446)	(44)	(2,288)
Commercial Real Estate	(142)	—	(15)	(7)	(69)
Agriculture	—	—	—	—	—
Residential Mortgage	—	(121)	(13)	(211)	(71)
Residential Construction	—	—	—	—	—
Consumer	(34)	(33)	(65)	(175)	(393)
Total Charged-Off	<u>(685)</u>	<u>(835)</u>	<u>(539)</u>	<u>(437)</u>	<u>(2,821)</u>
Recoveries:					
Commercial	46	302	37	102	58
Commercial Real Estate	—	—	—	18	—
Agriculture	—	—	81	—	—
Residential Mortgage	34	96	1	219	—
Residential Construction	131	5	5	60	86
Consumer	63	66	263	56	107
Total Recoveries	<u>274</u>	<u>469</u>	<u>387</u>	<u>455</u>	<u>251</u>
Net (Charge-offs) Recoveries	(411)	(366)	(152)	18	(2,570)
Balance at End of Year	<u>\$ 12,822</u>	<u>\$ 11,133</u>	<u>\$ 10,899</u>	<u>\$ 9,251</u>	<u>\$ 8,583</u>
Ratio of Net (Charge-Offs) Recoveries					
During the Year to Average Loans					
Outstanding During the Year	(0.05%)	(0.05%)	(0.02%)	0.00%	(0.49%)
Allowance as a percentage of Total Loans	1.65%	1.49%	1.60%	1.51%	1.57%
Allowance as a percentage of Non-performing loans, net of guarantees	250.4%	300.1%	258.5%	358.8%	166.5%

Allocation of the Allowance for Loan Losses

The Allowance for Loan Losses has been established as a general component available to absorb probable inherent losses throughout the loan portfolio. The following table is an allocation of the Allowance for Loan Losses balance on the dates indicated (dollars in thousands):

	December 31, 2018			December 31, 2017			December 31, 2016		
	Allocation of Allowance for Loan Losses Balance	Allowance as a % of Total Allowance	Loans as a % of Total Loans, net	Allocation of Allowance for Loan Losses Balance	Allowance as a % of Total Allowance	Loans as a % of Total Loans, net	Allocation of Allowance for Loan Losses Balance	Allowance as a % of Total Allowance	Loans as a % of Total Loans, net
Loan Type:									
Commercial	\$ 3,198	25.0%	16.1%	\$ 2,625	23.7%	18.0%	\$ 3,571	32.8%	18.3%
Commercial Real Estate	5,890	45.9%	54.2%	5,460	49.0%	53.2%	3,910	35.9%	50.9%
Agriculture	1,632	12.7%	15.9%	1,547	13.9%	15.2%	1,262	11.6%	15.0%
Residential Mortgage	643	5.0%	6.6%	628	5.6%	5.6%	660	6.0%	5.9%
Residential Construction	318	2.5%	2.6%	360	3.2%	2.8%	440	4.0%	3.5%
Consumer	279	2.2%	4.6%	342	3.1%	5.2%	498	4.6%	6.4%
Unallocated	862	6.7%	—	171	1.5%	—	558	5.1%	—
Total	\$ 12,822	100.0%	100.0%	\$ 11,133	100.0%	100.0%	\$ 10,899	100.0%	100.0%

	December 31, 2015			December 31, 2014		
	Allocation of Allowance for Loan Losses Balance	Allowance as a % of Total Allowance	Loans as a % of Total Loans, net	Allocation of Allowance for Loan Losses Balance	Allowance as a % of Total Allowance	Loans as a % of Total Loans, net
Loan Type:						
Commercial	\$ 3,097	33.5%	22.0%	\$ 3,581	41.7%	21.8%
Commercial Real Estate	3,343	36.1%	47.8%	1,825	21.2%	47.5%
Agriculture	1,060	11.5%	13.9%	580	6.8%	11.3%
Residential Mortgage	739	8.0%	7.0%	1,181	13.8%	9.2%
Residential Construction	334	3.6%	1.9%	161	1.9%	1.1%
Consumer	641	6.9%	7.4%	886	10.3%	9.1%
Unallocated	37	0.4%	—	369	4.3%	—
Total	\$ 9,251	100.0%	100.0%	\$ 8,583	100.0%	100.0%

The Bank believes that any breakdown or allocation of the allowance into loan categories lends an appearance of exactness, which does not exist, because the allowance is available for all loans. The allowance breakdown shown above is computed taking actual experience into consideration but should not be interpreted as an indication of the specific amount and allocation of actual charge-offs that may ultimately occur.

Deposits

The following table sets forth the average amount and the average rate paid on each of the listed deposit categories (dollars in thousands) during the periods specified:

Deposit Type:	2018		2017		2016	
	Average Amount	Average Rate	Average Amount	Average Rate	Average Amount	Average Rate
Non-interest-Bearing Demand	\$ 394,106	—	\$ 361,729	—	\$ 329,933	—
Interest-Bearing Demand (NOW)	\$ 307,727	0.14%	\$ 293,464	0.08%	\$ 269,197	0.11%
Savings and MMDAs	\$ 333,788	0.17%	\$ 335,709	0.16%	\$ 309,638	0.17%
Time	\$ 67,177	0.42%	\$ 77,705	0.39%	\$ 84,087	0.40%

The following table sets forth by time remaining to maturity the Bank's time deposits over \$250,000 (dollars in thousands) as of December 31, 2018:

Three months or less	\$ 3,848
Over three months through twelve months	6,414
Over twelve months	<u>5,741</u>
Total	<u>\$ 16,003</u>

Short-Term Borrowings

The Company had no secured borrowings and no Federal Funds purchased at December 31, 2018 and December 31, 2017.

Additional short-term borrowings available to the Company consist of a line of credit and advances from the Federal Home Loan Bank ("FHLB") secured under terms of a blanket collateral agreement by a pledge of FHLB stock and certain other qualifying collateral such as commercial and mortgage loans. At December 31, 2018, the Company had collateral borrowing capacity from the FHLB of \$325,150,000 and at such date, also had unsecured Federal Funds lines of credit totaling \$67,000,000 with correspondent banks.

Long-Term Borrowings

The Company had no long-term borrowings at December 31, 2018 and 2017. Average outstanding balances of long-term borrowings were \$0 during 2018 and 2017.

Supplemental Compensation Plans

The Company and the Bank maintain an unfunded non-contributory defined benefit pension plan ("Salary Continuation Plan") and related split dollar plan for a select group of highly compensated employees. Eligibility to participate in the Salary Continuation Plan is limited to a select group of management or highly compensated employees of the Bank that are designated by the Board. Additionally, the Company and the Bank adopted a supplemental executive retirement plan ("SERP") in 2006. The SERP is intended to integrate the various forms of retirement payments offered to executives. There are currently three participants in the SERP. At December 31, 2018, the accrued benefit liability was \$5,322,000, of which \$3,640,000 was recorded in interest payable and other liabilities and \$1,682,000 was recorded in accumulated other comprehensive loss, net in the Consolidated Statements of Condition. At December 31, 2017, the accrued benefit liability was \$5,419,000, of which \$3,450,000 was recorded in interest payable and other liabilities and \$1,969,000 was recorded in accumulated other comprehensive loss, net, in the Consolidated Statements of Condition.

The Company and the Bank maintain an unfunded non-contributory defined benefit pension plan ("Directors' Retirement Plan") and related split dollar plan for the directors of the Bank. At December 31, 2018 the accrued benefit liability was \$787,000, of which \$827,000 was recorded in interest payable and other liabilities and (\$40,000) was recorded in accumulated other comprehensive loss, net in the Consolidated Statements of Condition. At December 31, 2017, the accrued benefit liability was \$856,000, of which \$860,000 was recorded in interest payable and other liabilities and (\$4,000) was recorded in accumulated other comprehensive loss, net, in the Consolidated Statements of Condition.

For additional information, see Note 16 to the Consolidated Financial Statements in this Form 10-K.

Overview

Year Ended December 31, 2018 Compared to Year Ended December 31, 2017

Net income for the year ended December 31, 2018, was \$12.6 million, representing an increase of \$3.9 million, or 43.5%, compared to net income of \$8.7 million for the year ended December 31, 2017. The increase in net income was principally attributable to a \$5.6 million increase in interest income and a \$3.6 million decrease in provision for income taxes, which was partially offset by a \$1.5 million increase in provision for loan loss, a \$0.9 million decrease in non-interest income and a \$2.8 million increase in non-interest expense.

Total assets increased by \$32.2 million, or 2.6%, to \$1.250 billion as of December 31, 2018, compared to \$1.218 billion at December 31, 2017. The increase in total assets was mainly due to a \$25.5 million increase in net loans (including loans held-for-sale), a \$33.9 million increase in investment securities and a \$5.6 million increase in certificates of deposit, which was partially offset by a \$36.9 million decrease in cash and cash equivalents. Total deposits increased \$19.9 million, or 1.8%, to \$1.125 billion as of December 31, 2018, compared to \$1.105 billion at December 31, 2017.

Year Ended December 31, 2017 Compared to Year Ended December 31, 2016

Net income for the year ended December 31, 2017, was \$8.7 million, representing an increase of \$0.6 million, or 8.7%, compared to net income of \$8.1 million for the year ended December 31, 2016. The increase in net income was principally attributable to a \$4.1 million increase in interest income, a \$1.2 million decrease in provision for loan loss, and a \$0.9 million increase in non-interest income, which was partially offset by a \$2.0 million increase in non-interest expense and a \$3.4 million increase in provision for income tax. On December 22, 2017, the TCJA was signed into law. Among other changes, the new law provides a reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. As a result of the reduction in the corporate income tax rate, the Company re-measured its net deferred tax asset in December 2017 (as was required given the law was enacted in 2017 even though the tax rate reduction did not take effect until 2018). This re-measurement resulted in a reduction in the value of our net deferred tax asset of \$1.7 million, or \$0.14 per diluted share, which was recorded as additional income tax expense for 2017.

Total assets increased by \$50.9 million, or 4.4%, to \$1.218 billion as of December 31, 2017, compared to \$1.167 billion at December 31, 2016. The increase in total assets was mainly due to a \$67.1 million increase in net loans (including loans held-for-sale) and a \$3.7 million increase in investment securities, which was partially offset by a \$14.2 million decrease in certificates of deposit and a \$6.8 million decrease in cash and cash equivalents. Total deposits increased \$41.0 million, or 3.9%, to \$1.105 billion as of December 31, 2017, compared to \$1.064 billion at December 31, 2016.

Results of Operations

Net Interest Income

Net interest income is the excess of interest and fees earned on the Bank's loans, investment securities, federal funds sold and banker's acceptances over the interest expense paid on deposits, mortgage notes and other borrowed funds which are used to fund those assets. Net interest income is primarily affected by the yields on the Bank's interest-earning assets and interest-bearing liabilities outstanding during the period. The \$5,411,000 increase in the Bank's net interest income in 2018 from 2017 was driven by both increased volumes and interest rates. Average loan growth was the primary driver from a volume perspective, contributing \$3,099,000 in additional interest income vs. 2017. Increasing interest rates drove increases in income primarily from loans, due from banks and investments by \$975,000, \$942,000 and \$671,000 respectively while the rates on interest bearing deposit accounts only increased by \$225,000. The \$4,128,000 increase in the Bank's net interest income in 2017 from 2016 was driven primarily by increased volumes. Average loan and investment growth were the primary drivers from a volume perspective, contributing \$2,481,000 and \$1,024,000 in additional interest income vs. 2016, respectively. Increasing interest rates drove increases in income primarily impacting due from banks and investment securities by \$758,000 and \$140,000 respectively while the rates on interest bearing deposit accounts decreased by \$125,000. See "Analysis of Changes in Interest Income and Interest Expense" set forth on page 32 of this Annual Report on Form 10-K for a discussion of the effects of interest rates and loan/deposit volume on net interest income.

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. Our loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, remained at 3.50% during most of 2016. In December 2016, the prime rate increased 25 basis points to end the year at 3.75%. During 2017, the prime rate increased 75 basis points (25 basis points in each of March, June and December) to end the year at 4.50%. During 2018, the prime rate increased 100 basis points (25 basis points in each of March, June, September, and December) to end the year at 5.50%. The effective federal funds rate, which is the cost of immediately available overnight funds, remained at 0.50% during most of 2016. In December 2016, the effective federal funds rate increased 25 basis points to end the year at 0.75%. During 2017, the effective federal funds rate increased 75 basis points (25 basis points in each of March, June and December) to end the year at 1.50%. During 2018, the effective federal funds rate increased 100 basis points (25 basis points in each of March, June, September and December) to end the period at 2.50%.

We are primarily funded by core deposits, with non-interest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on our net interest income and net interest margin in a rising interest rate environment. Federal prohibitions on the payment of interest on demand deposits were repealed in 2011. Nonetheless, we have not experienced any significant additional costs as a result. However, as market interest rates have increased, we have increased the interest rates we pay on most of our interest-bearing deposit products.

The nature and impact of future changes in interest rates and monetary policy on the business and earnings of the Company cannot be predicted.

Interest income on loans for 2018 was up 12.3% from 2017, increasing from \$33,115,000 to \$37,189,000, and was up 7.9% from 2017 to 2016, increasing from \$30,697,000 to \$33,115,000. The increase in interest income on loans for 2018 as compared to 2017 was the result of a 9.1% increase in average loan volume and a 14 basis point increase in loan yields. The increase in interest income on loans for 2017 as compared to 2016 was the result of a 7.3% increase in average loan volume and a 3 basis point increase in loan yields.

Interest income on investment securities for 2018 was up 12.4% from 2017, increasing from \$5,019,000 to \$5,643,000, and was up 30.1% from 2017 to 2016, increasing from \$3,858,000 to \$5,019,000. The increase in interest income on investment securities for 2018 as compared to 2017 was the result of a 23 basis point increase in investment securities yields, which was partially offset by a 1.2% decrease in investment securities volume. The increase in interest income on investment securities for 2017 as compared to 2016 was the result of a 25.2% increase in average investment securities volume and a 6 basis point increase in investment securities yields. The Bank's strategy in 2018 was to use its excess cash to purchase investment securities and increase the investment portfolio. Investment securities yields were 1.92%, 1.69% and 1.63% for 2018, 2017, and 2016, respectively.

Interest income on interest-bearing due from banks for 2018 was up 51.5% from 2017, increasing from \$1,428,000 to \$2,163,000, and was up 91.4% from 2017 to 2016, increasing from \$746,000 to \$1,428,000. The increase in interest income on interest-bearing due from banks for 2018 as compared to 2017 was the result of an 80 basis point increase in yield on interest-bearing due from banks, which was partially offset by a 13.0% decrease in average balances of interest-bearing due from banks. The increase in interest income on interest-bearing due from banks for 2017 as compared to 2016 was the result of a 58 basis point increase in yield on interest-bearing due from banks, which was partially offset by a 9.3% decrease in average balances of interest-bearing due from banks.

Interest income on certificates of deposit for 2018 was up 44.4% from 2017, increasing from \$72,000 to \$104,000, and was down 50.3% from 2017 to 2016, decreasing from \$145,000 to \$72,000. The increase in interest income on certificates of deposit for 2018 as compared to 2017 was the result of a 146 basis point increase in yield on certificates of deposit, which was partially offset by a 39.9% decrease in average balances of certificates of deposit. The decrease in interest income on certificates of deposit for 2017 as compared to 2016 was the result of a 58.3% decrease in average balances of certificates of deposit, which was partially offset by a 17 basis point increase in yield on certificates of deposit.

Interest expense on deposits for 2018 was up 17.5% from 2017, increasing from \$1,079,000 to \$1,268,000, and was down 6.7% from 2017 to 2016, decreasing from \$1,157,000 to \$1,079,000. The increase in interest expense on deposits for 2018 as compared to 2017 was the result of a 3 basis point increase in interest rates paid on interest-bearing deposits and a 0.3% increase in average balances of interest-bearing deposits. The decrease in interest expense on deposits for 2017 as compared to 2016 was the result of a 2 basis point decrease in interest rates paid on interest-bearing deposits, which was partially offset by a 6.6% increase in average balances of interest-bearing deposits.

The mix of deposits for the previous three years was as follows (dollars in thousands):

	2018		2017		2016	
	Average Balance	Percent	Average Balance	Percent	Average Balance	Percent
Non-interest-Bearing Demand	\$ 394,106	35.7%	\$ 361,729	33.8%	\$ 329,933	33.2%
Interest-Bearing Demand (NOW)	307,727	27.9%	293,464	27.5%	269,197	27.1%
Savings and MMDAs	333,788	30.3%	335,709	31.4%	309,638	31.2%
Time	67,177	6.1%	77,705	7.3%	84,087	8.5%
Total	<u>\$ 1,102,798</u>	<u>100.0%</u>	<u>\$ 1,068,607</u>	<u>100.0%</u>	<u>\$ 992,855</u>	<u>100.0%</u>

Loan rates increased in 2018, 2017 and 2016. Deposit rates increased in 2018 and decreased in 2017 and 2016. The Bank's net interest margin (net interest income divided by average earning assets) was 3.83% in 2018, 3.48% in 2017 and 3.37% in 2016. The net spread between the rate for total earning assets and the rate for interest-bearing deposits and borrowed funds increased 33 basis points in the period from 2018 to 2017 and increased 12 basis points in the period from 2016 to 2017. The increase in 2018 from 2017 was primarily due to an overall increase in interest rates on earning assets, which was partially offset by an increase in interest rates on interest-bearing deposits.

Provision for Loan Losses

The provision for loan losses is established by charges to earnings based on management's overall evaluation of the collectability of the loan portfolio. Based on this evaluation, the provision for loan losses increased to \$2,100,000 in 2018 from \$600,000 in 2017, primarily as a result of an increase in specific reserves on impaired loans and an increase in loan balances. The amount of loans charged-off decreased in 2018 to \$685,000 from \$835,000 in 2017, and recoveries decreased to \$274,000 in 2018 from \$469,000 in 2017. The decrease in charge-offs was due to a decrease in charge-offs on commercial and residential mortgage loans, which was partially offset by an increase in charge-offs on commercial real estate loans. The ratio of the Allowance for Loan Losses to total loans at December 31, 2018 was 1.65% compared to 1.49% at December 31, 2017. The ratio of the Allowance for Loan Losses to total non-accrual loans and loans past due 90 days or more, net of guarantees was 250.4% at December 31, 2018, compared to 300.1% at December 31, 2017.

The provision for loan losses decreased to \$600,000 in 2017 from \$1,800,000 in 2016, primarily as a result of a decrease in specific reserves on impaired loans and improved credit quality, which was partially offset by an increase in loan balances as well as an increase in qualitative risk factors. The amount of loans charged-off increased in 2017 to \$835,000 from \$539,000 in 2016, and recoveries increased to \$469,000 in 2017 from \$387,000 in 2016. The increase in charge-offs was due to an increase in charge-offs on commercial and residential mortgage loans, which was partially offset by a decrease in charge-offs of commercial real estate and consumer loans. The ratio of the Allowance for Loan Losses to total loans at December 31, 2017 was 1.49% compared to 1.60% at December 31, 2016. The ratio of the Allowance for Loan Losses to total non-accrual loans and loans past due 90 days or more, net of guarantees was 300.1% at December 31, 2017, compared to 258.5% at December 31, 2016.

Non-Interest Income and Expenses

Non-interest income consisted primarily of service charges on deposit accounts, net gains on sales of investment securities, net realized gains on loans held-for-sale, and other income. Service charges on deposit accounts increased \$37,000 in 2018 over 2017 and decreased \$54,000 in 2017 over 2016. Realized gains on sale of investment securities decreased \$6,000 in 2018 over 2017 and decreased \$13,000 in 2017 over 2016. The decrease in 2018 was primarily due to a decrease in fair value of securities sold. Net realized gains on loans held-for-sale decreased \$175,000 in 2018 over 2017 and decreased \$330,000 in 2017 over 2016. The decrease in 2018 was primarily due to a decrease in the volume of loan sales. Other income increased \$412,000 in 2018 over 2017 and increased \$64,000 in 2017 over 2016. The increase in 2018 was due, for the most part, to increases in investment and brokerage income, fiduciary activities income and debit card income, which was partially offset by decreases in mortgage brokerage income and loan servicing income. In 2017, the Company recognized a pre-tax gain of \$1,187,000 on a sale-leaseback transaction related to land and building which is partially occupied by a Bank branch.

Non-interest expenses consisted primarily of salaries and employee benefits, occupancy and equipment expense, data processing expense, stationery and supplies expense, advertising and other expenses. Non-interest expenses increased to \$32,163,000 in 2018 from \$29,400,000 in 2017, and increased to \$29,400,000 in 2017 from \$27,352,000 in 2016, representing an increase of \$2,763,000, or 9.4%, in 2018 over 2017, and an increase of \$2,048,000, or 7.5%, in 2017 over 2016.

Following is an analysis of the increase or decrease in the components of non-interest expenses (dollars in thousands) during the periods specified:

	<u>2018 over 2017</u>		<u>2017 over 2016</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Salaries and Employee Benefits	\$ 2,511	13.7%	\$ 1,513	9.0%
Occupancy and Equipment	(87)	(3.0%)	(81)	(2.8%)
Data Processing	382	21.1%	238	15.2%
Stationery and Supplies	57	17.2%	(13)	(3.8%)
Advertising	45	13.7%	20	6.5%
Directors Fees	(13)	(4.2%)	18	6.2%
OREO Expense and Impairment	17	283.3%	4	200.0%
Other Expense	(149)	(2.7%)	349	6.8%
Total	<u>\$ 2,763</u>	<u>9.4%</u>	<u>\$ 2,048</u>	<u>7.5%</u>

The increase in salaries and employee benefits in 2018 was primarily due to a 12% increase in regular salaries and 6% increase in payroll taxes. The increase in regular salaries expense and related payroll tax expense was due to current year salary increases and increases in staffing levels. The increase in data processing expense was a result of core processing migration related costs and enhanced IT infrastructure. The decrease in occupancy and equipment expense in 2018 was primarily due to decreases in depreciation expense and utilities expense. The decrease in other expenses in 2018 was primarily due to decrease in provision for off-balance sheet loan losses, consulting fees, loan and lease expense, which was partially offset by increases in contributions expense and loan collection expense.

The increase in salaries and employee benefits in 2017 was primarily due to a 6% increase in regular salaries, 4% increase in payroll taxes, and 34% increase in profit sharing expense. The increase in regular salaries expense and related payroll tax expense was due to current year salary increases and increases in staffing levels. The increase in profit sharing expense was due to increased performance results of the Company. The decrease in occupancy and equipment expense in 2017 was primarily due to decreases in rent expense and depreciation expense. The decrease in rent expense was primarily due to the amortization of the deferred portion of the gain on sale of lease-back transaction discussed in Non-Interest Income above. The increase in data processing expense was a result of enhanced IT infrastructure costs. The increase in other expenses in 2017 was primarily due to an increase in amortization expense on housing tax credits, sundry losses, and off-balance sheet loan losses.

Income Taxes

The provision for income taxes is primarily affected by the tax rate, the level of earnings before taxes and the level of tax-exempt income. In 2018, tax expense decreased to \$4,744,000 from \$8,318,000 in 2017. In 2017, tax expense increased to \$8,318,000 from \$4,885,000 in 2016. On December 22, 2017, the TCJA was signed into law. Among other changes, the new law provided a reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018 and required the Company to re-measure its net deferred tax asset in December 2017. In 2018, the decrease in tax expense was primarily due to a decrease in the federal corporate income tax rate. In addition, in 2017 the Company recorded additional tax expense of \$1,700,000 for the reduction in the value of the Company's net deferred tax assets. In 2017, the increase in tax expense was primarily due to the re-measurement of net deferred tax asset and an increase in taxable income. Non-taxable municipal bond income was \$143,000, \$257,000, and \$276,000, for the years ended December 31, 2018, 2017, and 2016, respectively.

Liquidity

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of deposit customers and any debt repayment requirements. The Bank's principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available-for-sale investment portfolio. The Company held \$314,637,000 in total investment securities at December 31, 2018. Under certain deposit, borrowing, and other arrangements, the Company must hold and pledge investment securities as collateral. At December 31, 2018, such collateral requirements totaled approximately \$36,781,000. As a smaller source of liquidity, the Bank can utilize existing credit arrangements.

The Company's primary source of liquidity on a stand-alone basis is dividends from the Bank. As discussed in Part I (Item 1) of this Annual Report on Form 10-K, dividends from the Bank are subject to regulatory and corporate law restrictions.

Liquidity risk can result from the mismatching of asset and liability cash flows, or from disruptions in the financial markets. As discussed in Part I (Item 1) of this Annual Report on Form 10-K, the Bank experiences seasonal swings in deposits, which impact liquidity. Management has sought to address these seasonal swings by scheduling investment maturities and developing seasonal credit arrangements with the Federal Home Loan Bank, Federal Reserve Bank and Federal Funds lines of credit with correspondent banks. In addition, the ability of the Bank's real estate department to originate and sell loans into the secondary market has provided another tool for the management of liquidity. As of December 31, 2018, the Company has not created any special purpose entities to securitize assets or to obtain off-balance sheet funding.

The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Liquidity is measured by various ratios, the most common of which is the ratio of net loans (including loans held-for-sale) to deposits. This ratio was 68.1% on December 31, 2018, 67.0% on December 31, 2017, and 63.3% on December 31, 2016. At December 31, 2018 and 2017, the Bank's ratio of core deposits to total assets was 88.7% and 89.2%, respectively. Core deposits include demand deposits, interest-bearing transaction deposits, savings and money market deposit accounts, and time deposits \$250,000 or less. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. Management believes that the Bank's liquidity position was adequate in 2018. This is best illustrated by the change in the Bank's net non-core ratio, which explains the degree of reliance on non-core liabilities to fund long-term assets. At December 31, 2018, the Bank's net core funding dependence ratio, the difference between non-core funds, time deposits \$250,000 or more and brokered time deposits under \$250,000, and short-term investments to long-term assets, was (12.14%) as of December 31, 2018 and (12.22%) as of December 31, 2017. This ratio indicated at December 31, 2018, the Bank did not significantly rely upon non-core deposits and borrowings to fund the Bank's long-term assets, namely loans and investments. The Bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank's liquidity.

Commitments

The following table details the amounts and expected maturities of commitments as of December 31, 2018 (amounts in thousands):

Commitments	Maturities by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Commitments to extend credit					
Commercial	\$ 79,508	\$ 59,689	\$ 15,641	\$ 3,302	\$ 876
Commercial Real Estate	20,955	5,790	540	—	14,625
Agriculture	23,992	15,737	1,829	216	6,210
Residential Mortgage	1,961	750	—	55	1,156
Residential Construction	21,032	20,434	—	—	598
Consumer	54,535	15,012	3,990	9,059	26,474
Commitments to sell loans	570	570	—	—	—
Standby Letters of Credit	2,974	2,229	745	—	—
Total	\$ 205,527	\$ 120,211	\$ 22,745	\$ 12,632	\$ 49,939

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments. These loans have been sold to third parties without recourse, subject to customary default, representations and warranties, recourse for breaches of the terms of the sales contracts and payment default recourse.

Financial instruments, whose contract amounts represent credit risk at December 31 of the indicated years, were as follows (amounts in thousands):

	2018	2017
Undisbursed loan commitments	\$ 201,983	\$ 220,882
Standby letters of credit	2,974	2,635
Commitments to sell loans	570	1,283
	\$ 205,527	\$ 224,800

The Bank expects its liquidity position to remain strong in 2019 as the Bank expects to continue to grow into existing markets. The stock market remained volatile this past year, but with the overall trend being favorable. While the Bank did not experience an outflow of deposits in 2018, the potential of outflows still exists if the stock market values continue to improve. Regardless of the outcome, the Bank believes that it has the means to provide adequate liquidity for funding normal operations in 2019.

Capital

The Company believes a strong capital position is essential to the Company's continued growth and profitability. A solid capital base provides depositors and shareholders with a margin of safety, while allowing the Company to take advantage of profitable opportunities, support future growth and provide protection against any unforeseen losses.

At December 31, 2018, stockholders' equity totaled \$112.5 million, an increase of \$12.5 million from \$100.0 million at December 31, 2017. The increase was primarily due to net income of \$12.6 million. Also affecting capital in 2018 was paid in capital in the amount of \$0.5 million resulting from employee stock purchases and stock plan accruals. The Company's Tier 1 Leverage Capital ratio was 9.0% and 8.6% at December 31, 2018 and December 31, 2017, respectively. See the section entitled "Business – Capital Standards" for additional information.

The capital of the Company and the Bank historically have been maintained at a level that is in excess of regulatory guidelines for a "well capitalized" institution. The policy of annual stock dividends has, over time, allowed the Company to match capital and asset growth through retained earnings and a managed program of geographic growth.

ITEM 8 – FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Management's Report

FIRST NORTHERN COMMUNITY BANCORP AND SUBSIDIARY

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of First Northern Community Bancorp and subsidiary (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system was designed to ensure that material information regarding our operations is made available to management and the board of directors to provide them reasonable assurance that the published financial statements are fairly presented. There are limitations inherent in any internal control, such as the possibility of human error and the circumvention or overriding of controls. As a result, even effective internal controls can provide only reasonable assurance with respect to financial statement preparation. As conditions change over time so too may the effectiveness of internal controls.

An internal control significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects a company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. An internal control material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our management has evaluated our internal control over financial reporting as of December 31, 2018 based on the framework in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, our management concluded that our internal control over financial reporting was effective as of December 31, 2018.

/s/ Louise A. Walker

Louise A. Walker
President/Chief Executive Officer/Director
(Principal Executive Officer)

/s/ Kevin Spink

Kevin Spink
Executive Vice President/Chief Financial Officer
(Principal Financial Officer)

March 8, 2019

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of
First Northern Community Bancorp

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of First Northern Community Bancorp and subsidiary (the “Company”) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by COSO.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ **MOSS ADAMS LLP**

Los Angeles, California
March 8, 2019

We have served as the Company's auditor since 2006.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Consolidated Balance Sheets

December 31, 2018 and 2017

(in thousands, except shares and share amounts)

	<u>2018</u>	<u>2017</u>
Assets		
Cash and cash equivalents	\$ 116,032	\$ 152,892
Certificates of deposit	7,595	1,984
Investment securities – available-for-sale, at fair value (includes securities pledged to creditors with the right to sell or repledge of \$36,781 at December 31, 2018 and \$32,399 at December 31, 2017)	314,637	280,741
Loans (net of allowance for loan losses of \$12,822 at December 31, 2018 and \$11,133 at December 31, 2017)	763,393	739,112
Loans held-for-sale	2,295	1,040
Stock in Federal Home Loan Bank and other equity securities, at cost	6,019	5,567
Premises and equipment, net	6,646	6,248
Other real estate owned	1,092	—
Interest receivable and other assets	32,136	30,074
Total Assets	<u>\$ 1,249,845</u>	<u>\$ 1,217,658</u>
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Demand	\$ 416,493	\$ 382,157
Interest-bearing transaction deposits	312,697	312,569
Savings and MMDAs	332,514	336,592
Time, \$250,000 or less	46,905	54,531
Time, over \$250,000	16,003	18,891
Total Deposits	<u>1,124,612</u>	<u>1,104,740</u>
Interest payable and other liabilities	12,772	12,874
Total Liabilities	<u>1,137,384</u>	<u>1,117,614</u>
Commitments and contingencies (Note 10)		
Stockholders' Equity:		
Common stock, no par value; 16,000,000 shares authorized; 12,253,812 and 11,630,129 shares issued and outstanding at December 31, 2018 and 2017, respectively	92,618	85,583
Additional paid-in capital	977	977
Retained earnings	23,902	17,881
Accumulated other comprehensive loss, net	(5,036)	(4,397)
Total Stockholders' Equity	<u>112,461</u>	<u>100,044</u>
Total Liabilities and Stockholders' Equity	<u>\$ 1,249,845</u>	<u>\$ 1,217,658</u>

See accompanying notes to consolidated financial statements.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Consolidated Statements of Income
Years Ended December 31, 2018, 2017 and 2016
(in thousands, except per share amounts)

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Interest and dividend income:			
Interest and fees on loans	\$ 37,189	\$ 33,115	\$ 30,697
Due from banks interest bearing accounts	2,267	1,500	891
Investment securities:			
Taxable	5,500	4,762	3,582
Non-taxable	143	257	276
Other earning assets	518	383	521
Total interest and dividend income	<u>45,617</u>	<u>40,017</u>	<u>35,967</u>
Interest expense:			
Time deposits over \$250,000	78	78	67
Other deposits	1,190	1,001	1,090
Total interest expense	<u>1,268</u>	<u>1,079</u>	<u>1,157</u>
Net interest income	44,349	38,938	34,810
Provision for loan losses	<u>2,100</u>	<u>600</u>	<u>1,800</u>
Net interest income after provision for loan losses	<u>42,249</u>	<u>38,338</u>	<u>33,010</u>
Non-interest income:			
Service charges on deposit accounts	1,994	1,957	2,011
Net loss on sale of available-for-sale securities	(20)	(14)	(1)
Net gain on sale of loans held-for-sale	337	512	842
Net gain on sale of other real estate owned	—	—	4
Gain on sale-leaseback of real estate	—	1,187	—
Other income	4,898	4,486	4,422
Total non-interest income	<u>7,209</u>	<u>8,128</u>	<u>7,278</u>
Non-interest expenses:			
Salaries and employee benefits	20,795	18,284	16,771
Occupancy and equipment	2,775	2,862	2,943
Data processing	2,190	1,808	1,570
Stationery and supplies	389	332	345
Advertising	373	328	308
Directors fees	296	309	291
Other real estate owned expense and impairment	23	6	2
Other expense	5,322	5,471	5,122
Total non-interest expenses	<u>32,163</u>	<u>29,400</u>	<u>27,352</u>
Income before provision for income tax	17,295	17,066	12,936
Provision for income tax	(4,744)	(8,318)	(4,885)
Net income	<u>\$ 12,551</u>	<u>\$ 8,748</u>	<u>\$ 8,051</u>
Basic income per share	<u>\$ 1.04</u>	<u>\$ 0.72</u>	<u>\$ 0.67</u>
Diluted income per share	<u>\$ 1.02</u>	<u>\$ 0.71</u>	<u>\$ 0.66</u>

See accompanying notes to consolidated financial statements.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Consolidated Statements of Comprehensive Income
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Net income	\$ 12,551	\$ 8,748	\$ 8,051
Other comprehensive loss, net of tax:			
Unrealized holding losses on securities arising during the current period, net of tax effect of (\$355), (\$570), and (\$1,218) for the years ended December 31, 2018, December 31, 2017, and December 31, 2016, respectively	(884)	(854)	(1,829)
Reclassification adjustment due to losses realized on sales of securities, net of tax effect of \$6, \$6, and \$0 for the years ended December 31, 2018, December 31, 2017, and December 31, 2016, respectively	14	8	1
Officers' retirement plan equity adjustments, net of tax effect of \$82, (\$236), and (\$16) for the years ended December 31, 2018, December 31, 2017, and December 31, 2016, respectively	205	(591)	(24)
Directors' retirement plan equity adjustments, net of tax effect of \$10, (\$7), and (2) for the years ended December 31, 2018, December 31, 2017, and December 31, 2016, respectively	26	(11)	(3)
Total other comprehensive loss, net of tax effect of (\$257), (\$807), and (\$1,236) for the years ended December 31, 2018, December 31, 2017, and December 31, 2016, respectively	<u>(639)</u>	<u>(1,448)</u>	<u>(1,855)</u>
Comprehensive income	<u>\$ 11,912</u>	<u>\$ 7,300</u>	<u>\$ 6,196</u>

See accompanying notes to consolidated financial statements.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Consolidated Statement of Stockholders' Equity
Years Ended December 31, 2018, 2017 and 2016
(in thousands, except share data)

	<u>Common Stock</u>		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
	Shares	Amounts				
Balance at December 31, 2015	10,676,557	\$ 73,764	\$ 977	\$ 11,603	\$ (495)	\$ 85,849
Net income				8,051		8,051
Other comprehensive loss, net of tax					(1,855)	(1,855)
Stock dividend adjustment	505	4		(4)		—
4% stock dividend declared in 2017	428,786	5,088		(5,088)		—
Cash in lieu of fractional shares	(101)			(5)		(5)
Stock-based compensation		286				286
Tax deficiency related to expired, vested non-qualified stock options		(114)				(114)
Common shares issued related to restricted stock grants and ESPP, net of restricted stock reversals	34,976	61				61
Stock options exercised	7,723	25				25
Balance at December 31, 2016	<u>11,148,446</u>	<u>\$ 79,114</u>	<u>\$ 977</u>	<u>\$ 14,557</u>	<u>\$ (2,350)</u>	<u>\$ 92,298</u>
Net income				8,748		8,748
Other comprehensive loss, net of tax					(1,448)	(1,448)
Stock dividend adjustment	289	207		(207)		—
Tax Rate Change Reclassification				599	(599)	—
4% stock dividend declared in 2018	447,312	5,806		(5,806)		—
Cash in lieu of fractional shares	(129)			(10)		(10)
Stock-based compensation		378				378
Common shares issued related to restricted stock grants and ESPP, net of restricted stock reversals	34,211	78				78
Balance at December 31, 2017	<u>11,630,129</u>	<u>\$ 85,583</u>	<u>\$ 977</u>	<u>\$ 17,881</u>	<u>\$ (4,397)</u>	<u>\$ 100,044</u>
Net income				12,551		12,551
Other comprehensive loss, net of tax					(639)	(639)
Stock dividend adjustment	628	240		(240)		—
5% stock dividend declared in 2019	583,514	6,280		(6,280)		—
Cash in lieu of fractional shares	(159)			(10)		(10)
Stock-based compensation		424				424
Common shares issued related to restricted stock grants and ESPP	33,722	91				91
Stock options exercised, net	5,978					—
Balance at December 31, 2018	<u>12,253,812</u>	<u>\$ 92,618</u>	<u>\$ 977</u>	<u>\$ 23,902</u>	<u>\$ (5,036)</u>	<u>\$ 112,461</u>

See accompanying notes to consolidated financial statements.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Consolidated Statements of Cash Flows
Years Ended December 31, 2018, 2017 and 2016
(in thousands)

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:			
Net income	\$ 12,551	\$ 8,748	\$ 8,051
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	2,100	600	1,800
Stock based compensation	424	378	286
Gain on sale-leaseback of real estate	-	(1,187)	—
Depreciation and amortization of bank premises and equipment	565	600	633
Accretion and amortization of securities, net	2,530	3,587	3,158
Net loss on sale/call of available-for-sale securities	20	14	1
Net gain on sale of loans held-for-sale	(337)	(512)	(842)
Net gain on sale of other real estate owned	—	—	(4)
(Reversal of) provision for deferred income taxes	(1,210)	1,919	(437)
Valuation adjustment on mortgage servicing rights	—	(21)	21
Proceeds from sales of loans held-for-sale	21,966	27,596	41,822
Originations of loans held-for-sale	(22,884)	(24,798)	(43,955)
Increase (decrease) in deferred loan origination fees and costs, net	328	57	(97)
(Increase) decrease in interest receivable and other assets	(596)	(2,147)	(793)
Net increase in interest payable and other liabilities	222	1,261	62
Net cash provided by operating activities	<u>15,679</u>	<u>16,095</u>	<u>9,706</u>
Cash flows from investing activities:			
Proceeds from maturities of available-for-sale securities	23,860	21,290	37,464
Proceeds from sales of available-for-sale securities	2,487	462	1,945
Principal repayments on available-for-sale securities	50,186	50,354	36,698
Purchase of available-for-sale securities	(114,198)	(80,779)	(176,041)
Net (increase) decrease in Certificates of Deposit	(5,611)	14,229	436
Net increase in stock in Federal Home Loan Bank and other equity securities, at cost	(452)	(1,158)	(475)
Net increase in loans	(27,801)	(69,999)	(65,837)
Purchases of bank premises and equipment, net	(963)	(1,225)	(926)
Proceeds from the sale of bank premises and equipment	—	2,868	—
Proceeds from sales of other real estate owned	—	—	221
Net cash used in investing activities	<u>(72,492)</u>	<u>(63,958)</u>	<u>(166,515)</u>
Cash flows from financing activities:			
Net increase in deposits	19,872	41,044	115,582
Cash dividends paid in lieu of fractional shares	(10)	(10)	(5)
Common stock issued	91	78	61
Stock options exercised	—	—	21
Tax benefit for stock options	—	—	(4)
Net cash provided by financing activities	<u>19,953</u>	<u>41,112</u>	<u>115,655</u>
Net decrease in cash and cash equivalents	<u>(36,860)</u>	<u>(6,751)</u>	<u>(41,154)</u>
Cash and cash equivalents at beginning of year	<u>152,892</u>	<u>159,643</u>	<u>200,797</u>
Cash and cash equivalents at end of year	<u>\$ 116,032</u>	<u>\$ 152,892</u>	<u>\$ 159,643</u>

Supplemental Consolidated Statements of Cash Flows Information (Note 19)

See accompanying notes to consolidated financial statements.

**FIRST NORTHERN COMMUNITY BANCORP
AND SUBSIDIARY**

Notes to Consolidated Financial Statements
Years Ended December 31, 2018, 2017 and 2016
(in thousands, except shares and share amounts)

(1) Summary of Significant Accounting Policies

First Northern Community Bancorp (“Company”) is a bank holding company whose only subsidiary, First Northern Bank of Dixon (“Bank”), a California state-chartered bank, conducts general banking activities, including collecting deposits and originating loans, and serves Solano, Yolo, Sacramento, Placer, El Dorado, and Contra Costa Counties. All intercompany transactions between the Company and the Bank have been eliminated in consolidation. The consolidated financial statements also include the accounts of Yolano Realty Corporation, a wholly-owned subsidiary of the Bank. Yolano Realty Corporation was formed in September 2009 for the purpose of managing selected other real estate owned properties. Yolano Realty Corporation was an inactive subsidiary in 2018.

The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates applied in the preparation of the accompanying consolidated financial statements. For the Company, the most significant accounting estimates are the allowance for loan losses, recognition and measurement of impaired loans, other-than-temporary impairment of securities, fair value measurements, share based compensation, valuation of mortgage servicing rights and deferred tax asset realization. A summary of the significant accounting policies applied in the preparation of the accompanying consolidated financial statements follows.

(a) Cash Equivalents

For purposes of the consolidated statements of cash flows, the Company considers due from banks, federal funds sold for one-day periods and short-term bankers acceptances to be cash equivalents. At times, the Company maintains deposits with other financial institutions in amounts that may exceed federal deposit insurance coverage. Management regularly evaluates the credit risk associated with correspondent banks.

(b) Investment Securities

Investment securities consist of U.S. Treasury securities, U.S. Agency securities, obligations of states and political subdivisions, obligations of U.S. Corporations, collateralized mortgage obligations and mortgage-backed securities. At the time of purchase of a security the Company designates the security as held-to-maturity or available-for-sale, based on its investment objectives, operational needs, and intent to hold. The Company does not purchase securities with the intent to engage in trading activity.

Held-to-maturity securities are recorded at amortized cost, adjusted for amortization or accretion of premiums or discounts. Available-for-sale securities are recorded at fair value with unrealized holding gains and losses, net of the related tax effect, reported as a separate component of stockholders’ equity until realized. The amortized cost of available-for-sale securities is adjusted for amortization of premiums and accretion of discounts over the life of the related security using the effective interest method. Such amortization and accretion is included in investment income, along with interest and dividends. The cost of securities sold is based on the specific identification method; realized gains and losses resulting from such sales are included in earnings.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each consolidated financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other than temporary. This assessment includes consideration regarding the duration and severity of impairment, the credit quality of the issuer and a determination of whether the Company intends to sell the security, or if it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. Other-than-temporary impairment is recognized in earnings if one of the following conditions exists: 1) the Company’s intent is to sell the security; 2) it is more likely than not that the Company will be required to sell the security before the impairment is recovered; or 3) the Company does not expect to recover its amortized cost basis. If, by contrast, the Company does not intend to sell the security and will not be required to sell the security prior to recovery of the amortized cost basis, the Company recognizes only the credit loss component of other-than-temporary impairment in earnings. The credit loss component is calculated as the difference between the security’s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security’s fair value and the present value of the future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income.

(c) Federal Home Loan Bank Stock and Other Equity Securities, at Cost

Federal Home Loan Bank (FHLB) stock represents an equity interest that does not have a readily determinable fair value because its ownership is restricted and it lacks a market (liquidity). FHLB stock and other securities are recorded at cost.

(d) Loans

Loans are reported at the principal amount outstanding, net of deferred loan fees and the allowance for loan losses. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. For a loan that has been restructured, the contractual terms of the loan agreement refer to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. Restructured loans are loans on which concessions in terms have been granted because of the borrowers' financial difficulties. A restructuring constitutes a troubled debt restructuring, and thus an impaired loan, if the restructuring constitutes a concession and the debtor is experiencing financial difficulties. An impaired loan is measured based upon the present value of future cash flows discounted at the loan's effective rate, the loan's observable market price, or the fair value of collateral if the loan is collateral dependent. Interest on impaired loans is recognized on a cash basis. If the measurement of the impaired loan is less than the recorded investment in the loan, an impairment is recognized by a charge to the allowance for loan losses.

Unearned discount on installment loans is recognized as income over the terms of the loans by the interest method. Interest on other loans is calculated by using the simple interest method on the daily balance of the principal amount outstanding.

Loan fees net of certain direct costs of origination, which represent an adjustment to interest yield are deferred and amortized over the contractual term of the loan using the interest method.

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is discontinued either when reasonable doubt exists as to the full and timely collection of interest or principal or when a loan becomes contractually past due by ninety days or more with respect to interest or principal. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed against current period interest income. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest. Accrual of interest on loans that are troubled debt restructurings commence after a sustained period of performance. Interest is generally accrued on such loans in accordance with the new terms.

(e) Loans Held-for-Sale

Loans originated and held-for-sale are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income.

(f) Allowance for Loan Losses

The allowance for loan losses is established through a provision charged to expense. It is the Company's policy to charge-off loans when the following exists: management determines that a loss is expected or when specified by regulatory examination; impairment analysis shows an impaired amount, which requires a partial charge-off; interest and/or principal are past due 90 days or more unless the credit is both well secured and in process of collection; consumer loans become 90 days delinquent, except those well secured by real estate collateral and in the process of collection; loan is canceled as part of a court judgment.

The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans and overdrafts on evaluations of collectability and prior loss experience. The loan portfolio is segregated into loan types to facilitate the assessment of risk to pools of loans based on historical charge-off experience and internal and external factors. Individual loans are reviewed for impairment, while all other loans, including individually evaluated loans determined not to be impaired, are collectively evaluated for impairment. The evaluations take into consideration internal and external factors such as trends in portfolio volume, maturity and composition, overall portfolio quality, loan concentrations, levels of and trends in charge-offs and recoveries, current and anticipated economic conditions that may affect the borrowers' ability to pay and national and local economic trends and conditions. While management uses these evaluations to determine the allowance for loan losses, additional provisions may be necessary based on changes in the factors used in the evaluations.

Material estimates relating to the determination of the allowance for loan losses are particularly susceptible to significant change in the near term. Management believes that the allowance for loan losses was adequate at December 31, 2018. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions and other factors. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additional allowance based on their judgment about information available to them at the time of their examination.

(g) Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed substantially by the straight-line method over the estimated useful lives of the related assets. Leasehold improvements are depreciated over the estimated useful lives of the improvements or the terms of the related leases, whichever is shorter. The useful lives used in computing depreciation are as follows:

improvements	Buildings and	15 to 50 years
equipment	Furniture and	3 to 10 years

(h) Other Real Estate Owned

Other real estate acquired by foreclosure is carried at fair value less estimated selling costs. Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for loan losses, if necessary. Fair value of other real estate owned is generally determined based on an appraisal of the property. Any subsequent operating expenses or income, reduction in estimated values and gains or losses on disposition of such properties are included in other operating expenses.

Gain recognition on the disposition of real estate is dependent upon the transaction meeting certain criteria relating to the nature of the property sold and the terms of the sale. Under certain circumstances, revenue recognition may be deferred until these criteria are met.

The Bank held other real estate owned ("OREO") in the amount of \$1,092 and \$0 as of December 31, 2018 and 2017, respectively.

(i) Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

Long-lived assets and certain identifiable intangibles are required to be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company currently has no identifiable intangible assets. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(j) Revenue from Contracts with Customers

In May 2014, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 specifies a standardized approach for revenue recognition across industries and transactions. The scope of this ASU does not include revenue streams covered by other ASU topics. Our revenue is comprised of net interest income on financial assets and financial liabilities and non-interest income. All of our net interest income and a portion of our non-interest income is excluded from the scope of Topic 606. The contracts that are in scope are primarily related to service charges and fees on deposit accounts, debit card income, investment and brokerage income and fiduciary activities income. We adopted the requirements of ASU 2014-09 on January 1, 2018. We have analyzed all revenue streams and determined our revenue recognition practices in scope of Topic 606 did not change in any material regard upon adoption of this ASU. The following are descriptions of the Company's sources of Non-interest income within the scope of Topic 606:

Service charges on deposit accounts

Service charges on deposit accounts include account maintenance and analysis fees and transaction-based fees. Account maintenance and analysis fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees consist of non-sufficient funds fees, wire fees, overdraft fees and fees on other products and services and are charged to deposit customers for specific services provided to the customer. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

Investment and brokerage services income

The Bank earns investment and brokerage services fees for providing a broad range of alternative investment products and services through Raymond James Financial Services, Inc. Brokerage fees are generally earned in two ways. Brokerage fees for managed accounts charge a set annual percentage fee based on the underlying portfolio value and are earned and recognized on a quarterly basis. Brokerage fees for a standard commission account are charged on a per transaction fee and are earned and recognized at the time of the transaction.

Mortgage brokerage income

The Bank earns a brokerage fee for originating mortgage loans for other institutions. The loans are underwritten and funded by other institutions. The brokerage fee is a percentage of the total loan amount. The performance obligation is satisfied and fees are recognized once underwriting is completed and the loan has been funded.

Debit card income

Debit card income represent fees earned on Bank-issued debit card transactions. The Bank earns interchange fees from debit cardholder transactions through the related payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' account. Certain expenses directly associated with the debit card are recorded on a net basis with the interchange income.

Gains (losses) on sales of available-for-sale securities

Gains and losses on sales of available-for-sale securities are from the sale of investment securities. The gain or loss is recognized upon settlement of the sale transaction.

Other income

Other income within the scope of Topic 606 include check sales fees, bankcard fees, merchant fees and increase in cash surrender value of life insurance policies. Check sales fees, based on check sales volume, are received from check printing companies and are recognized monthly. Bankcard fees are earned from the Bank's credit card program and are recognized monthly as the service period is completed. Merchant fees are earned for card payment services provided to its merchant customers. The Bank has a contract with a third party to provide card payment services to merchants that contract for those services. Merchant fees are recognized monthly as the service period is completed. The Bank owns life insurance policies on certain officers and directors of the Bank. The increase in cash surrender value of life insurance policies is recognized on a monthly basis based upon the current expected cash surrender value of the underlying life insurance policies.

(k) *Gain or Loss on Sale of Loans and Servicing Rights*

Transfers and servicing of financial assets and extinguishments of liabilities are accounted for and reported based on consistent application of a financial-components approach that focuses on control. Transfers of financial assets that are sales are distinguished from transfers that are secured borrowings. A sale is recognized when the transaction closes and the proceeds are other than beneficial interests in the assets sold. A gain or loss is recognized to the extent that the sales proceeds and the fair value of the servicing asset exceed or are less than the book value of the loan. Additionally, a normal cost for servicing the loan is considered in the determination of the gain or loss.

The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold. The Company sold substantially all of its conforming long-term residential mortgage loans originated during the years ended December 31, 2018, 2017, and 2016 for cash proceeds equal to the fair value of the loans.

Mortgage servicing rights (MSR) in loans sold are measured by allocating the previous carrying amount of the transferred assets between the loans sold and retained interest, if any, based on their relative fair value at the date of transfer. The Company determines its classes of servicing assets based on the asset type being serviced along with the methods used to manage the risk inherent in the servicing assets, which includes the market inputs used to value the servicing assets. The Company measures and reports its residential mortgage servicing assets initially at fair value and amortizes the servicing rights in proportion to, and over the period of, estimated net servicing revenues. Management assesses servicing rights for impairment as of each financial reporting date. Fair value adjustments that encompass market-driven valuation changes and the runoff in value that occurs from the passage of time are each separately reported.

In determining the fair value of the MSR, the Company uses quoted market prices when available. Subsequent fair value measurements are determined using a discounted cash flow model. In order to determine the fair value of the MSR, the present value of expected future cash flows is estimated. Assumptions used include market discount rates, anticipated prepayment speeds, delinquency and foreclosure rates, and ancillary fee income. This model is periodically validated by an independent external model validation group. The model assumptions and the MSR fair value estimates are also compared to observable trades of similar portfolios as well as to MSR broker valuations and industry surveys, as available. Key assumptions used in measuring the fair value of MSR as of December 31 were as follows:

	<u>2018</u>	<u>2017</u>
Constant prepayment rate	8.58%	10.80%
Discount rate	10.01%	10.02%
Weighted average life (years)	6.79	6.02

The expected life of the loan can vary from management's estimates due to prepayments by borrowers, especially when rates fall. Prepayments in excess of management's estimates would negatively impact the recorded value of the mortgage servicing rights. The value of the mortgage servicing rights is also dependent upon the discount rate used in the model, which we base on current market rates. Management reviews this rate on an ongoing basis based on current market rates. A significant increase in the discount rate would reduce the value of mortgage servicing rights.

(l) Income Taxes

The Company accounts for income taxes under the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(m) Share Based Compensation

The Company accounts for stock-based payment transactions whereby the Company receives employee services in exchange for equity instruments, including stock options and restricted stock. The Company recognizes in the consolidated statements of income the grant-date fair value of stock options and other equity-based forms of compensation issued to employees over their requisite service period (generally the vesting period). The fair value of options granted is determined on the date of the grant using a Black-Scholes-Merton pricing model. The grant date fair value of restricted stock is determined by the closing market price of the day prior to the grant date. The Company issues new shares of common stock upon the exercise of stock options. See Note 14 of Notes to Consolidated Financial Statements.

(n) Earnings Per Share ("EPS")

Basic EPS includes no dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period, excluding non-vested restricted shares. Diluted EPS reflects the potential dilution of securities that could share in the earnings of an entity. The number of potential common shares included in annual diluted EPS is a year to date average of the number of potential common shares included in each quarter's diluted EPS computation under the treasury stock method. The calculation of weighted average shares includes two classes of the Company's outstanding common stock: common stock and restricted stock awards. Holders of restricted stock also receive dividends at the same rate as common shareholders, subject to vesting restrictions, and they both share equally in undistributed earnings. See Note 13 of Notes to Consolidated Financial Statements.

(o) Advertising Costs

Advertising costs were \$373, \$328, and \$308 for the years ended December 31, 2018, 2017, and 2016, respectively. Advertising costs are expensed as incurred.

(p) Comprehensive Income

Accounting principles generally accepted in the United States require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gain and losses on available-for-sale securities and directors' and officers' retirement plans, are reported as a separate component of the equity section of the consolidated balance sheet. Such items, along with net income, are components of comprehensive income.

(q) Stock Dividend

On January 25, 2018, the Company announced that its Board of Directors had declared a 4% stock dividend which resulted in 447,940 shares, which was paid on March 29, 2018 to shareholders of record as of February 28, 2018. On January 24, 2019, the Company announced that its Board of Directors had declared a 5% stock dividend which will result in an estimate of 583,514 shares, which will be paid on March 29, 2019 to shareholders of record as of February 28, 2019.

The earnings per share data for all periods presented have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019. December 31, 2018 figures included in the Consolidated Balance Sheets and Consolidated Statement of Changes in Stockholders' Equity have been adjusted to reflect the estimated impact of the 2019 stock dividend. Figures that have been adjusted include common stock shares issued and outstanding, Common stock balance and Retained earnings balance. The December 31, 2017, 2016 and 2015 balances included in the Consolidated Balance Sheets and Statement of Changes in Stockholders' Equity have not been adjusted to retroactively reflect the stock dividends, but instead show the historical rollforward of stock dividends declared.

(r) Segment Reporting

The "Segment Reporting" topic of the FASB ASC requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank, which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernible lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, the Company only reports one segment.

(s) Impact of Recently Issued Accounting Standards

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The amendments in ASU 2016-02, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

- A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
- A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

In July 2018, FASB issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. These amendments provide entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases). The amendments also provide lessors with a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue guidance (Topic 606) and certain criteria are met. For entities that have not adopted Topic 842 before the issuance of ASU 2018-11, the effective date and transition requirements for the amendments related to separating components of a contract are the same as the effective date and transition requirements in ASU 2016-02. The Company adopted this optional transition method upon adoption of ASU 2016-02 on January 1, 2019.

The amendments in these ASU's are effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company adopted ASU 2016-02 on January 1, 2019. As a result, the Company recognized a lease liability and right-of-use asset of approximately \$4,800 and \$4,400, which were recognized in other liabilities and other assets, respectively.

In June 2016, FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in ASU 2016-13, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments are effective for public companies for annual periods beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the potential impact of ASU 2016-13 on our financial statements. In that regard, we have formed a cross-functional working group, under the direction of our Chief Financial Officer and our Chief Credit Officer. The working group is comprised of individuals from various functional areas including credit risk, finance and information technology, among others. We are currently working through our implementation plan which includes assessment and documentation of processes, internal controls and data sources; model development and documentation; and system configuration, among other things. We are also in the process of implementing a third-party vendor solution to assist us in the application of the ASU 2016-13. The adoption of the ASU 2016-13 could result in an increase in the allowance for loan losses as a result of changing from an “incurred loss” model, which encompasses allowances for current known and inherent losses within the portfolio, to an “expected loss” model, which encompasses allowances for losses expected to be incurred over the life of the portfolio. Furthermore, ASU 2016-13 will necessitate that we establish an allowance for expected credit losses for certain debt securities and other financial assets. While we are currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption will be significantly influenced by the composition, characteristics and quality of our loan and securities portfolios as well as the prevailing economic conditions and forecasts as of the adoption date.

In August 2018, FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. These amendments modify various disclosure requirements in Topic 820. For all entities, amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In August 2018, FASB issued ASU 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*. These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. For public business entities, amendments are effective for fiscal years ending after December 15, 2020. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

In August 2018, FASB issued ASU 2018-15, *Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*. ASU 2018-15 clarifies certain aspects of ASU 2015-05, “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” which was issued in April 2015. Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 does not affect the accounting for the service element of a hosting arrangement that is a service contract. ASU 2018-15 will be effective for the Company on January 1, 2020, with early adoption permitted, and is not expected to have a significant impact on its financial statements.

In November 2018, FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses*. The guidance clarifies that receivables arising from operating leases are not within the scope of the credit losses standard, but rather should be accounted for in accordance with the leases standard. The effective date and transition requirements are the same as the effective dates and transition requirements in the credit losses standard, ASU 2016-13. The Company does not expect the adoption of this update to have a significant impact on its consolidated financial statements.

(2) Cash and Due from Banks

The Bank is required to maintain reserves with the Federal Reserve Bank based on a percentage of deposit liabilities. No aggregate reserves were required at December 31, 2018 and 2017. The Bank has met its average reserve requirements during 2018, 2017, and 2016 and the minimum required balance at December 31, 2018 and 2017.

(3) Investment Securities

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2018 are summarized as follows:

	<u>Amortized cost</u>	<u>Unrealized gains</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>
Investment securities available-for-sale:				
U.S. Treasury securities	\$ 50,825	\$ 14	\$ (157)	\$ 50,682
Securities of U.S. government agencies and corporations	42,215	89	(228)	42,076
Obligations of states and political subdivisions	19,110	181	(123)	19,168
Collateralized mortgage obligations	65,615	34	(1,850)	63,799
Mortgage-backed securities	142,297	147	(3,532)	138,912
Total debt securities	<u>\$ 320,062</u>	<u>\$ 465</u>	<u>\$ (5,890)</u>	<u>\$ 314,637</u>

The amortized cost, unrealized gains and losses and estimated fair values of investments in debt and other securities at December 31, 2017 are summarized as follows:

	<u>Amortized cost</u>	<u>Unrealized gains</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>
Investment securities available-for-sale:				
U.S. Treasury Securities	\$ 18,589	\$ —	\$ (125)	\$ 18,464
Securities of U.S. government agencies and corporations	21,353	—	(244)	21,109
Obligations of states and political subdivisions	23,138	216	(146)	23,208
Collateralized mortgage obligations	67,724	—	(1,641)	66,083
Mortgage-backed securities	154,143	95	(2,361)	151,877
Total debt securities	<u>\$ 284,947</u>	<u>\$ 311</u>	<u>\$ (4,517)</u>	<u>\$ 280,741</u>

Gross realized gains from sales and calls of available-for-sale securities were \$0, \$2, and \$24 for the years ended December 31, 2018, 2017, and 2016, respectively. Gross realized losses from sales of available-for-sale securities were \$20, \$16, and \$25 for the years ended December 31, 2018, 2017, and 2016, respectively.

The amortized cost and estimated fair value of debt and other securities at December 31, 2018, by contractual and expected maturity, are shown in the following table:

	<u>Amortized cost</u>	<u>Estimated fair value</u>
Maturity in years:		
Due in one year or less	\$ 47,277	\$ 47,114
Due after one year through five years	58,881	58,648
Due after five years through ten years	5,462	5,628
Due after ten years	530	536
Subtotal	112,150	111,926
MBS and CMO	207,912	202,711
Total	<u>\$ 320,062</u>	<u>\$ 314,637</u>

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. In addition, factors such as prepayments and interest rates may affect the yield on the carrying value of mortgage-related securities.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2018, follows:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized losses</u>	<u>Fair Value</u>	<u>Unrealized losses</u>	<u>Fair Value</u>	<u>Unrealized losses</u>
U.S. Treasury securities	\$ 37,805	\$ (67)	\$ 5,951	\$ (90)	\$ 43,756	\$ (157)
Securities of U.S. government agencies and corporations	16,959	(39)	13,540	(189)	30,499	(228)
Obligations of states and political subdivisions	847	(2)	9,134	(121)	9,981	(123)
Collateralized mortgage obligations	2,217	(6)	53,217	(1,844)	55,434	(1,850)
Mortgage-backed securities	16,358	(123)	105,361	(3,409)	121,719	(3,532)
Total	<u>\$ 74,186</u>	<u>\$ (237)</u>	<u>\$ 187,203</u>	<u>\$ (5,653)</u>	<u>\$ 261,389</u>	<u>\$ (5,890)</u>

No decline in value was considered “other-than-temporary” during 2018. Sixty-four securities, all considered investment grade, which had a fair value of \$74,186 and a total unrealized loss of \$237 have been in an unrealized loss position for less than twelve months as of December 31, 2018. One hundred eighty-six securities, all considered investment grade, which had a fair value of \$187,203 and a total unrealized loss of \$5,653, have been in an unrealized loss position for more than twelve months as of December 31, 2018. The unrealized losses on the Company's investment securities were caused by market conditions for these types of investments, particularly changes in risk-free interest rates. The Company does not intend to sell the securities and has concluded it is not more likely than not that we will be required to sell these securities prior to recovery of their anticipated cost basis. Therefore, the Company does not consider these investments to be other than temporarily impaired as of December 31, 2018.

The fair value of investment securities could decline in the future if the general economy deteriorates, inflation increases, credit ratings decline, the issuer's financial condition deteriorates, or the liquidity for securities declines. As a result, other than temporary impairments may occur in the future.

An analysis of gross unrealized losses of the available-for-sale investment securities portfolio as of December 31, 2017, follows:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized losses</u>	<u>Fair Value</u>	<u>Unrealized losses</u>	<u>Fair Value</u>	<u>Unrealized losses</u>
U.S. Treasury Securities	\$ 10,004	\$ (2)	\$ 8,460	\$ (123)	\$ 18,464	\$ (125)
Securities of U.S. government agencies and corporation	6,049	(50)	15,060	(194)	21,109	(244)
Obligations of states and political subdivision	7,677	(34)	7,116	(112)	14,793	(146)
Collateralized mortgage obligations	31,679	(576)	34,404	(1,065)	66,083	(1,641)
Mortgage-backed securities	62,320	(650)	76,478	(1,711)	138,798	(2,361)
Total	<u>\$ 117,729</u>	<u>\$ (1,312)</u>	<u>\$ 141,518</u>	<u>\$ (3,205)</u>	<u>\$ 259,247</u>	<u>\$ (4,517)</u>

Investment securities carried at \$36,781 and \$32,399 at December 31, 2018 and 2017, respectively, were pledged to secure public deposits or for other purposes as required or permitted by law.

(4) Loans

The composition of the Company's loan portfolio, by loan class, at December 31, is as follows:

	2018	2017
Commercial	\$ 125,177	\$ 135,015
Commercial Real Estate	420,106	398,346
Agriculture	123,626	113,555
Residential Mortgage	51,064	42,081
Residential Construction	20,124	21,299
Consumer	35,397	38,900
	<u>775,494</u>	<u>749,196</u>
Allowance for loan losses	(12,822)	(11,133)
Net deferred origination fees and costs	721	1,049
	<u>763,393</u>	<u>739,112</u>
Loans, net	<u>\$ 763,393</u>	<u>\$ 739,112</u>

The Company manages asset quality and credit risk by maintaining diversification in its loan portfolio and through review processes that include analysis of credit requests and ongoing examination of outstanding loans and delinquencies, with particular attention to portfolio dynamics and loan mix. The Company strives to identify loans experiencing difficulty early enough to correct the problems, to record charge-offs promptly based on realistic assessments of collectability and current collateral values and to maintain an adequate allowance for loan losses at all times. Asset quality reviews of loans and other non-performing assets are administered using credit risk rating standards and criteria similar to those employed by state and federal banking regulatory agencies.

Commercial loans, whether secured or unsecured, generally are made to support the short-term operations and other needs of small businesses. These loans are generally secured by the receivables, equipment, and other real property of the business and are susceptible to the related risks described above. Problem commercial loans are generally identified by periodic review of financial information that may include financial statements, tax returns, and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation.

Commercial real estate loans generally fall into two categories, owner-occupied and non-owner occupied. Loans secured by owner-occupied real estate are primarily susceptible to changes in the market conditions of the related business. This may be driven by, among other things, industry changes, geographic business changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles. These same risks apply to Commercial loans whether secured by equipment, receivables or other personal property or unsecured. Problem commercial real estate loans are generally identified by periodic review of financial information that may include financial statements, tax returns, payment history of the borrower, and site inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary. Losses on loans secured by owner occupied real estate, equipment, or other personal property generally are dictated by the value of underlying collateral at the time of default and liquidation of the collateral. When default is driven by issues related specifically to the business owner, collateral values tend to provide better repayment support and may result in little or no loss. Alternatively, when default is driven by more general economic conditions, underlying collateral generally has devalued more and results in larger losses due to default. Loans secured by non-owner occupied real estate are primarily susceptible to risks associated with swings in occupancy or vacancy and related shifts in lease rates, rental rates or room rates. Most often, these shifts are a result of changes in general economic or market conditions or overbuilding and resulting over-supply of space. Losses are dependent on the value of underlying collateral at the time of default. Values are generally driven by these same factors and influenced by interest rates and required rates of return as well as changes in occupancy costs. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, sales invoices, or other appropriate means.

Agricultural loans, whether secured or unsecured, generally are made to producers and processors of crops and livestock. Repayment is primarily from the sale of an agricultural product or service. Agricultural loans are generally secured by inventory, receivables, equipment, and other real property. Agricultural loans primarily are susceptible to changes in market demand for specific commodities. This may be exacerbated by, among other things, industry changes, changes in the individual financial capacity of the business owner, general economic conditions and changes in business cycles, as well as adverse weather conditions such as drought or floods. Problem agricultural loans are generally identified by periodic review of financial information that may include financial statements, tax returns, crop budgets, payment history, and crop inspections. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors. Notwithstanding, when repayment becomes unlikely based on the borrower's income and cash flow, repossession or foreclosure of the underlying collateral may become necessary.

Residential mortgage loans, which are secured by real estate, are primarily susceptible to four risks; non-payment due to diminished or lost income, over-extension of credit, a lack of borrower's cash flow to sustain payments, and shortfalls in collateral value. In general, non-payment is usually due to loss of employment and follows general economic trends in the economy, particularly the upward movement in the unemployment rate, loss of collateral value, and demand shifts.

Construction loans, whether owner-occupied or non-owner occupied residential development loans, are not only susceptible to the related risks described above but the added risks of construction, including cost over-runs, mismanagement of the project, or lack of demand and market changes experienced at time of completion. Losses are primarily related to underlying collateral value and changes therein as described above. Problem construction loans are generally identified by periodic review of financial information that may include financial statements, tax returns and payment history of the borrower. Based on this information, the Company may decide to take any of several courses of action, including demand for repayment, requiring the borrower to provide a significant principal payment and/or additional collateral or requiring similar support from guarantors, or repossession or foreclosure of the underlying collateral. Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation.

Consumer loans, whether unsecured or secured, are primarily susceptible to four risks: non-payment due to diminished or lost income, over-extension of credit, a lack of borrower's cash flow to sustain payments, and shortfall in collateral value. In general, non-payment is usually due to loss of employment and will follow general economic trends in the economy, particularly the upward movements in the unemployment rate, loss of collateral value, and demand shifts.

Collateral values may be determined by appraisals obtained through Bank-approved, licensed appraisers, qualified independent third parties, purchase invoices, or other appropriate documentation. Collateral valuations are obtained at origination of the credit and periodically thereafter (generally annually but may be more frequent depending on the collateral type), once repayment is questionable, and the loan has been deemed classified.

As of December 31, 2018, approximately 16% in principal amount of the Company's loans were for general commercial uses, including professional, retail and small businesses. Approximately 54% in principal amount of the Company's loans were secured by commercial real estate, which consists primarily of loans secured by commercial properties and construction and land development loans. Approximately 16% in principal amount of the Company's loans were for agriculture, approximately 7% in principal amount of the Company's loans were residential mortgage loans, approximately 3% in principal amount of the Company's loans were residential construction loans and approximately 4% in principal amount of the Company's loans were consumer loans.

Once a loan becomes delinquent or repayment becomes questionable, a Company collection officer will address collateral shortfalls with the borrower and attempt to obtain additional collateral or a principal payment. If this is not forthcoming and payment of principal and interest in accordance with the contractual terms of the loan agreement becomes unlikely, the Company will consider the loan to be impaired and will estimate its probable loss, using the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. For collateral dependent loans, the Company will utilize a recent valuation of the underlying collateral less estimated costs of sale, and charge-off the loan down to the estimated net realizable amount. Depending on the length of time until final collection, the Company may periodically revalue the estimated loss and take additional charge-offs or specific reserves as warranted. Revaluations may occur as often as every 3-12 months depending on the underlying collateral and volatility of values. Final charge-offs or recoveries are taken when the collateral is liquidated and the actual loss is confirmed. Unpaid balances on loans after or during collection and liquidation may also be pursued through legal action and attachment of wages or judgment liens on the borrower's other assets.

At December 31, 2018 and December 31, 2017, all loans were pledged under a blanket collateral lien to secure actual and potential borrowings from the Federal Home Loan Bank.

Non-accrual and Past Due Loans

The Company's loans by delinquency and non-accrual status, as of December 31, 2018 and December 31, 2017 was as follows:

	Current & Accruing	30-59 Days Past Due & Accruing	60-89 Days Past Due & Accruing	90 Days or more Past Due & Accruing	Nonaccrual	Total Loans
December 31, 2018						
Commercial	\$ 123,765	\$ 662	\$ —	\$ —	\$ 750	\$ 125,177
Commercial Real Estate	419,725	—	—	—	381	420,106
Agriculture	118,639	157	—	—	4,830	123,626
Residential Mortgage	50,964	—	—	—	100	51,064
Residential Construction	20,124	—	—	—	—	20,124
Consumer	35,054	114	38	—	191	35,397
Total	<u>\$ 768,271</u>	<u>\$ 933</u>	<u>\$ 38</u>	<u>\$ —</u>	<u>\$ 6,252</u>	<u>\$ 775,494</u>
December 31, 2017						
Commercial	\$ 133,913	\$ —	\$ —	\$ 45	\$ 1,057	\$ 135,015
Commercial Real Estate	396,521	101	—	—	1,724	398,346
Agriculture	113,555	—	—	—	—	113,555
Residential Mortgage	40,354	349	597	—	781	42,081
Residential Construction	21,299	—	—	—	—	21,299
Consumer	38,656	1	38	—	205	38,900
Total	<u>\$ 744,298</u>	<u>\$ 451</u>	<u>\$ 635</u>	<u>\$ 45</u>	<u>\$ 3,767</u>	<u>\$ 749,196</u>

Non-accrual loans amounted to \$6,252 at December 31, 2018 and were comprised of two commercial loans totaling \$750, two commercial real estate loans totaling \$381, five agriculture loans totaling \$4,830, two residential mortgage loans totaling \$100, and one consumer loan totaling \$191. Non-accrual loans amounted to \$3,767 at December 31, 2017 and were comprised of three commercial loans totaling \$1,057, three commercial real estate loans totaling \$1,724, three residential mortgage loans totaling \$781, and one consumer loan totaling \$205. All non-accrual loans are measured for impairment based upon the present value of future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of collateral, if the loan is collateral dependent. If the measurement of the non-accrual loan is less than the recorded investment in the loan, an impairment is recognized through the establishment of a specific reserve sufficient to cover expected losses and/or a charge-off against the allowance for loan losses. If the loan is considered to be collateral dependent, it is generally the Company's policy to charge-off the portion of any non-accrual loan that the Company does not expect to collect by writing the loan down to the estimated net realizable value of the underlying collateral. There was a \$261 commitment to lend additional funds to a borrower whose loan was on non-accrual status at December 31, 2018.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Loans to be considered for impairment include non-accrual loans, troubled debt restructurings and loans with a risk rating of 5 (special mention) or worse and an aggregate exposure of \$500,000 or more. Once identified, impaired loans are measured individually for impairment using one of three methods: present value of expected cash flows discounted at the loan's effective interest rate; the loan's observable market price; or fair value of collateral if the loan is collateral dependent. In general, any portion of the recorded investment in a collateral dependent loan in excess of the fair value of the collateral that can be identified as uncollectible, and is, therefore, deemed a confirmed loss, is promptly charged-off against the allowance for loan losses.

Impaired loans, segregated by loan class, as of December 31, 2018 and December 31, 2017 were as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
December 31, 2018					
Commercial	\$ 3,591	\$ 300	\$ 2,602	\$ 2,902	\$ 496
Commercial Real Estate	780	381	261	642	21
Agriculture	4,830	4,830	—	4,830	—
Residential Mortgage	1,669	100	1,451	1,551	287
Residential Construction	560	—	560	560	49
Consumer	403	191	198	389	2
Total	<u>\$ 11,833</u>	<u>\$ 5,802</u>	<u>\$ 5,072</u>	<u>\$ 10,874</u>	<u>\$ 855</u>
December 31, 2017					
Commercial	\$ 3,882	\$ 1,057	\$ 2,603	\$ 3,660	\$ 53
Commercial Real Estate	2,114	1,724	272	1,996	36
Agriculture	—	—	—	—	—
Residential Mortgage	2,628	781	1,496	2,277	302
Residential Construction	651	—	650	650	76
Consumer	418	205	213	418	3
Total	<u>\$ 9,693</u>	<u>\$ 3,767</u>	<u>\$ 5,234</u>	<u>\$ 9,001</u>	<u>\$ 470</u>

The average recorded investment in impaired loans and the amount of interest income recognized on impaired loans during the years ended December 31, 2018, 2017, and 2016 was as follows:

	December 31, 2018		December 31, 2017		December 31, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 2,986	\$ 181	\$ 3,980	\$ 157	\$ 3,276	\$ 33
Commercial Real Estate	1,681	15	1,780	15	857	16
Agriculture	966	—	—	—	—	—
Residential Mortgage	1,834	72	2,543	92	3,131	93
Residential Construction	612	28	732	37	945	44
Consumer	439	27	548	26	736	71
Total	<u>\$ 8,518</u>	<u>\$ 323</u>	<u>\$ 9,583</u>	<u>\$ 327</u>	<u>\$ 8,945</u>	<u>\$ 257</u>

None of the interest on impaired loans was recognized using a cash basis of accounting for the years ended December 31, 2018, 2017, and 2016.

Troubled Debt Restructurings

The Company's loan portfolio includes certain loans that have been modified in a Troubled Debt Restructuring ("TDR"), which are loans on which concessions in terms have been granted because of the borrowers' financial difficulties and, as a result, the Company receives less than the current market-based compensation for the loan. These concessions may include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are placed on non-accrual status at the time of restructure and may be returned to accruing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

When a loan is modified, it is measured based upon the present value of future cash flows discounted at the contractual interest rate of the original loan agreement, or the fair value of collateral less selling costs if the loan is collateral dependent. If the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through a specific allowance or a charge-off of the loan.

The Company had \$4,813 and \$5,896 in TDR loans as of December 31, 2018 and December 31, 2017, respectively. Specific reserves for TDR loans totaled \$405 and \$470 as of December 31, 2018 and December 31, 2017, respectively. TDR loans performing in compliance with modified terms totaled \$4,622 and \$5,234 as of December 31, 2018 and December 31, 2017, respectively. There were no commitments to advance additional funds on existing TDR loans as of December 31, 2018.

Loans modified as troubled debt restructurings during the year ended December 31, 2018, 2017, and 2016 were as follows:

Year Ended December 31, 2018			
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Consumer	1	\$ 191	\$ 191
Total	1	\$ 191	\$ 191

Year Ended December 31, 2017			
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Commercial	1	\$ 2,410	\$ 2,410
Total	1	\$ 2,410	\$ 2,410

Year Ended December 31, 2016			
	Number of Contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
Commercial	2	\$ 5,180	\$ 5,180
Total	2	\$ 5,180	\$ 5,180

Loan modifications generally involve reductions in the interest rate, payment extensions, forgiveness of principal, or forbearance. There were no troubled debt restructurings modified within the previous 12 months and for which there was a payment default during the year ended December 31, 2018 and December 31, 2017. There was one commercial loan with a recorded investment of \$5,000 that was modified as a troubled debt restructuring within the previous 12 months and for which there was a payment default during the year ended December 31, 2016. The Company considers a loan to be in payment default when it is 90 days or more past due.

Credit Quality Indicators

All new loans are rated using the credit risk ratings and criteria adopted by the Company. Risk ratings are adjusted as future circumstances warrant. All credits risk rated 1, 2, 3 or 4 equate to a Pass as indicated by Federal and State regulatory agencies; a 5 equates to a Special Mention; a 6 equates to Substandard; a 7 equates to Doubtful; and an 8 equates to a Loss. General definitions for each risk rating are as follows:

Risk Rating “1” – Pass (High Quality): This category is reserved for loans fully secured by Company CD’s or savings accounts and properly margined (as defined in the Company’s Credit Policy) and actively traded securities (including stocks, as well as corporate, municipal and U.S. Government bonds).

Risk Rating “2” – Pass (Above Average Quality): This category is reserved for borrowers with strong balance sheets that are well structured with manageable levels of debt and good liquidity. Cash flow is sufficient to service all debt, including the Company’s, as agreed. Historical earnings, cash flow, and payment performance have all been strong and trends are positive and consistent. Collateral protection is better than the Company’s Credit Policy guidelines.

Risk Rating “3” – Pass (Average Quality): Credits within this category are considered to be of average, but acceptable, quality. Loan characteristics, including term and collateral advance rates, meet the Company’s Credit Policy guidelines; unsecured lines to borrowers with above average liquidity and cash flow may be considered for this category; the borrower’s financial strength is well documented, with adequate, but consistent, cash flow to meet all obligations. Liquidity should be sufficient and leverage should be moderate. Monitoring of collateral may be required, including a borrowing base or construction budget. Alternative financing is typically available.

Risk Rating “4” – Pass (Below Average Quality): Credits within this category are considered sound, but merit additional attention due to industry concentrations within the borrower’s customer base, problems within their industry, deteriorating financial or earnings trends, declining collateral values, increased frequency of past due payments and/or overdrafts, discovery of documentation deficiencies which may impair our borrower’s ability to repay, or the Company’s ability to liquidate collateral. Financial performance is average but inconsistent. There also may be changes of ownership, management or professional advisors, which could be detrimental to the borrower’s future performance.

Risk Rating “5” – Special Mention (Criticized): Loans in this category are currently protected by their collateral value and have no loss potential identified, but have potential weaknesses which may, if not monitored or corrected, weaken our ability to collect payments from the borrower or satisfactorily liquidate our collateral position. Loans where terms have been modified due to their failure to perform as agreed may be included in this category. Adverse trends in the borrower’s operation, such as reporting losses or inadequate cash flow, increasing and unsatisfactory leverage, or an adverse change in economic or market conditions may have weakened the borrower’s business and impaired their ability to repay based on original terms. The condition or value of the collateral has deteriorated to the point where adequate protection for our loan may be jeopardized in the future. Loans in this category are in transition and, generally, do not remain in this category beyond 12 months. During this time, efforts are focused on strategies aimed at upgrading the credit or locating alternative financing.

Risk Rating “6” – Substandard (Classified): Loans in this category are inadequately protected by the borrower’s net worth, capacity to repay or collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. There exists a strong possibility of loss if the deficiencies are not corrected. Loans that are dependent on the liquidation of collateral to repay are included in this category, as well as borrowers in bankruptcy or where legal action is required to effect collection of our debt.

Risk Rating “7” – Doubtful (Classified): Loans in this category indicate all of the weaknesses of a Substandard classification, however, collection of loan principal, in full, is highly questionable and improbable; possibility of loss is very high, but there is still a possibility that certain collection strategies may, yet, be successful, rendering a definitive loss difficult to estimate, at this time. Loans in this category are in transition and, generally, do not remain in this category more than 6 months.

Risk Rating “8” – Loss (Classified):

Active Charge-Off. Loans in this category are considered uncollectible and of such little value that their removal from the Company’s books is required. The charge-off is pending or already processed. Collateral positions have been or are in the process of being liquidated and the borrower/guarantor may or may not be cooperative in repayment of the debt. Recovery prospects are unknown at this time, but we are still actively engaged in the collection of the loan.

Inactive Charge-Off. Loans in this category are considered uncollectible and of such little value that their removal from the Company’s books is required. The charge-off is pending or already processed. Collateral positions have been liquidated and the borrower/guarantor has nothing of any value remaining to apply to the repayment of our loan. Any further collection activities would be of little value.

The following table presents the risk ratings by loan class as of December 31, 2018 and December 31, 2017.

	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Loss</u>	<u>Total</u>
December 31, 2018						
Commercial	\$ 121,848	\$ 66	\$ 2,813	\$ 450	\$ —	\$ 125,177
Commercial Real Estate	395,436	14,272	10,398	—	—	420,106
Agriculture	104,809	11,750	7,067	—	—	123,626
Residential Mortgage	50,149	—	915	—	—	51,064
Residential Construction	19,372	752	—	—	—	20,124
Consumer	34,272	590	535	—	—	35,397
Total	<u>\$ 725,886</u>	<u>\$ 27,430</u>	<u>\$ 21,728</u>	<u>\$ 450</u>	<u>\$ —</u>	<u>\$ 775,494</u>
December 31, 2017						
Commercial	\$ 132,846	\$ 1,050	\$ 1,119	\$ —	\$ —	\$ 135,015
Commercial Real Estate	378,632	16,101	3,613	—	—	398,346
Agriculture	110,370	3,140	45	—	—	113,555
Residential Mortgage	39,142	2,147	792	—	—	42,081
Residential Construction	21,299	—	—	—	—	21,299
Consumer	38,157	500	243	—	—	38,900
Total	<u>\$ 720,446</u>	<u>\$ 22,938</u>	<u>\$ 5,812</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 749,196</u>

Allowance for Loan Losses

The following table details activity in the allowance for loan losses by loan category for the years ended December 31, 2018, 2017 and 2016.

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Residential Mortgage</u>	<u>Residential Construction</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
Balance as of								
December 31, 2017	\$ 2,625	\$ 5,460	\$ 1,547	\$ 628	\$ 360	\$ 342	\$ 171	\$ 11,133
Provision for loan losses	1,036	572	85	(19)	(173)	(92)	691	2,100
Charge-offs	(509)	(142)	—	—	—	(34)	—	(685)
Recoveries	46	—	—	34	131	63	—	274
Net charge-offs	(463)	(142)	—	34	131	29	—	(411)
Ending Balance	<u>3,198</u>	<u>5,890</u>	<u>1,632</u>	<u>643</u>	<u>318</u>	<u>279</u>	<u>862</u>	<u>12,822</u>
Period-end amount allocated to:								
Loans individually evaluated for impairment	496	21	—	287	49	2	—	855
Loans collectively evaluated for impairment	<u>2,702</u>	<u>5,869</u>	<u>1,632</u>	<u>356</u>	<u>269</u>	<u>277</u>	<u>862</u>	<u>11,967</u>
Balance as of								
December 31, 2018	<u>\$ 3,198</u>	<u>\$ 5,890</u>	<u>\$ 1,632</u>	<u>\$ 643</u>	<u>\$ 318</u>	<u>\$ 279</u>	<u>\$ 862</u>	<u>\$ 12,822</u>
	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Residential Mortgage</u>	<u>Residential Construction</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
Balance as of December 31, 2016	\$ 3,571	\$ 3,910	\$ 1,262	\$ 660	\$ 440	\$ 498	\$ 558	\$ 10,899
Provision for loan losses	(567)	1,550	285	(7)	(85)	(189)	(387)	600
Charge-offs	(681)	—	—	(121)	—	(33)	—	(835)
Recoveries	302	—	—	96	5	66	—	469
Net charge-offs	(379)	—	—	(25)	5	33	—	(366)
Ending Balance	<u>2,625</u>	<u>5,460</u>	<u>1,547</u>	<u>628</u>	<u>360</u>	<u>342</u>	<u>171</u>	<u>11,133</u>
Period-end amount allocated to:								
Loans individually evaluated for impairment	53	36	—	302	76	3	—	470
Loans collectively evaluated for impairment	<u>2,572</u>	<u>5,424</u>	<u>1,547</u>	<u>326</u>	<u>284</u>	<u>339</u>	<u>171</u>	<u>10,663</u>
Balance as of December 31, 2017	<u>\$ 2,625</u>	<u>\$ 5,460</u>	<u>\$ 1,547</u>	<u>\$ 628</u>	<u>\$ 360</u>	<u>\$ 342</u>	<u>\$ 171</u>	<u>\$ 11,133</u>

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Residential Mortgage</u>	<u>Residential Construction</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
Balance as of December 31, 2015	\$ 3,097	\$ 3,343	\$ 1,060	\$ 739	\$ 334	\$ 641	\$ 37	\$ 9,251
Provision for loan losses	883	582	121	(67)	101	(341)	521	1,800
Charge-offs	(446)	(15)	—	(13)	—	(65)	—	(539)
Recoveries	37	—	81	1	5	263	—	387
Net charge-offs	(409)	(15)	81	(12)	5	198	—	(152)
Ending Balance	<u>3,571</u>	<u>3,910</u>	<u>1,262</u>	<u>660</u>	<u>440</u>	<u>498</u>	<u>558</u>	<u>10,899</u>
Period-end amount allocated to:								
Loans individually evaluated for impairment	898	39	—	584	98	25	—	1,644
Loans collectively evaluated for impairment	<u>2,673</u>	<u>3,871</u>	<u>1,262</u>	<u>76</u>	<u>342</u>	<u>473</u>	<u>558</u>	<u>9,255</u>
Balance as of December 31, 2016	<u>\$ 3,571</u>	<u>\$ 3,910</u>	<u>\$ 1,262</u>	<u>\$ 660</u>	<u>\$ 440</u>	<u>\$ 498</u>	<u>\$ 558</u>	<u>\$ 10,899</u>

The Company's investment in loans as of December 31, 2018, 2017, and 2016 related to each balance in the allowance for loan losses by loan category and disaggregated on the basis of the Company's impairment methodology was as follows:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Residential Mortgage</u>	<u>Residential Construction</u>	<u>Consumer</u>	<u>Total</u>
December 31, 2018							
Loans individually evaluated for impairment	\$ 2,902	\$ 642	\$ 4,830	\$ 1,551	\$ 560	\$ 389	\$ 10,874
Loans collectively evaluated for impairment	<u>122,275</u>	<u>419,464</u>	<u>118,796</u>	<u>49,513</u>	<u>19,564</u>	<u>35,008</u>	<u>764,620</u>
Ending Balance	<u>\$ 125,177</u>	<u>\$ 420,106</u>	<u>\$ 123,626</u>	<u>\$ 51,064</u>	<u>\$ 20,124</u>	<u>\$ 35,397</u>	<u>\$ 775,494</u>
December 31, 2017							
Loans individually evaluated for impairment	\$ 3,660	\$ 1,996	\$ —	\$ 2,277	\$ 650	\$ 418	\$ 9,001
Loans collectively evaluated for impairment	<u>131,355</u>	<u>396,350</u>	<u>113,555</u>	<u>39,804</u>	<u>20,649</u>	<u>38,482</u>	<u>740,195</u>
Ending Balance	<u>\$ 135,015</u>	<u>\$ 398,346</u>	<u>\$ 113,555</u>	<u>\$ 42,081</u>	<u>\$ 21,299</u>	<u>\$ 38,900</u>	<u>\$ 749,196</u>
December 31, 2016							
Loans individually evaluated for impairment	\$ 5,578	\$ 823	\$ —	\$ 3,034	\$ 820	\$ 704	\$ 10,959
Loans collectively evaluated for impairment	<u>120,733</u>	<u>343,387</u>	<u>101,905</u>	<u>37,203</u>	<u>22,830</u>	<u>42,546</u>	<u>668,604</u>
Ending Balance	<u>\$ 126,311</u>	<u>\$ 344,210</u>	<u>\$ 101,905</u>	<u>\$ 40,237</u>	<u>\$ 23,650</u>	<u>\$ 43,250</u>	<u>\$ 679,563</u>

(5) Mortgage Operations

Transfers and servicing of financial assets and extinguishments of liabilities are accounted for and reported based on consistent application of a financial-components approach that focuses on control. Transfers of financial assets that are sales are distinguished from transfers that are secured borrowings. Retained interests (mortgage servicing rights) in loans sold are measured by allocating the previous carrying amount of the transferred assets between the loans sold and retained interests, if any, based on their relative fair value at the date of transfer. Fair values are estimated using discounted cash flows based on a current market interest rate.

The Company recognizes a gain and a related asset for the fair value of the rights to service loans for others when loans are sold. The Company sold substantially its entire portfolio of conforming long-term residential mortgage loans originated during the year ended December 31, 2018 for cash proceeds equal to the fair value of the loans. At December 31, 2018 and December 31, 2017, the Company serviced real estate mortgage loans for others totaling \$211,845 and \$221,591, respectively.

The recorded value of mortgage servicing rights is amortized in proportion to, and over the period of, estimated net servicing revenues. The Company assesses capitalized mortgage servicing rights for impairment based upon the fair value of those rights at each reporting date. For purposes of measuring impairment, the rights are stratified based upon the product type, term and interest rates. Fair value is determined by discounting estimated net future cash flows from mortgage servicing activities using discount rates that approximate current market rates and estimated prepayment rates, among other assumptions. The amount of impairment recognized, if any, is the amount by which the capitalized mortgage servicing rights for a stratum exceeds their fair value. Impairment, if any, is recognized through a valuation allowance for each individual stratum. Changes in the carrying amount of mortgage servicing rights are reported in earnings under other operating income on the condensed consolidated statements of income.

The following table summarizes the activity related to the Company's mortgage servicing rights assets for the years ended December 31, 2018, December 31, 2017 and December 31, 2016. Mortgage servicing rights are included in Interest Receivable and Other Assets on the consolidated balance sheets.

	December 31, 2017	Additions	Reductions	December 31, 2018
Mortgage servicing rights	\$ 1,712	\$ 141	\$ (274)	\$ 1,579
Valuation allowance	—	—	—	—
Mortgage servicing rights, net of valuation allowance	<u>\$ 1,712</u>	<u>\$ 141</u>	<u>\$ (274)</u>	<u>\$ 1,579</u>

	December 31, 2016	Additions	Reductions	December 31, 2017
Mortgage servicing rights	\$ 1,815	\$ 229	\$ (332)	\$ 1,712
Valuation allowance	(21)	—	21	—
Mortgage servicing rights, net of valuation allowance	<u>\$ 1,794</u>	<u>\$ 229</u>	<u>\$ (311)</u>	<u>\$ 1,712</u>

	December 31, 2015	Additions	Reductions	December 31, 2016
Mortgage servicing rights	\$ 1,862	\$ 348	\$ (395)	\$ 1,815
Valuation allowance	—	(169)	148	(21)
Mortgage servicing rights, net of valuation allowance	<u>\$ 1,862</u>	<u>\$ 179</u>	<u>\$ (247)</u>	<u>\$ 1,794</u>

At December 31, 2018 and December 31, 2017, the estimated fair market value of the Company's mortgage servicing rights asset was \$2,091 and \$1,876, respectively.

The Company received contractually specified servicing fees of \$549, \$575, and \$598 for the years ended December 31, 2018, 2017, and 2016, respectively. Contractually specified servicing fees are included in Other Income on the consolidated statements of income.

(6) Premises and Equipment

Premises and equipment consist of the following at December 31 of the indicated years:

	2018	2017
Land	\$ 2,679	\$ 2,679
Buildings	5,103	5,006
Furniture and equipment	11,930	11,206
Leasehold improvements	2,002	1,987
	<u>21,714</u>	<u>20,878</u>
Less accumulated depreciation and amortization	<u>15,068</u>	<u>14,630</u>
	<u>\$ 6,646</u>	<u>\$ 6,248</u>

Depreciation and amortization expense, included in occupancy and equipment expense, was \$565, \$600, and \$633 for the years ended December 31, 2018, 2017, and 2016, respectively.

(7) Interest Receivable and other assets

Interest receivable and other assets consisted of the following at December 31 of the indicated years:

	2018	2017
Interest receivable	\$ 4,158	\$ 4,117
Mortgage servicing rights asset	1,579	1,712
Officer's Life Insurance	16,262	15,821
Investment in Limited Partnerships	—	291
Deferred tax assets, net (see Note 17)	6,016	4,548
Prepaid and other	4,121	3,585
	<u>\$ 32,136</u>	<u>\$ 30,074</u>

(8) Short-Term and Long-Term Borrowings

The Company had no secured borrowings and no Federal Funds purchased at December 31, 2018 and December 31, 2017.

Additional short-term borrowings available to the Company consist of a line of credit and advances with the Federal Home Loan Bank ("FHLB") secured under terms of a blanket collateral agreement by a pledge of FHLB stock and all loans. At December 31, 2018, the Company had a current collateral borrowing capacity with the FHLB of \$325,150 and, at such date, also had unsecured formal lines of credit totaling \$67,000 with correspondent banks.

The Company had no long-term borrowings at December 31, 2018 and 2017. Average outstanding balances of long-term borrowings consisting of FHLB advances were \$0 during 2018, 2017, and 2016. The weighted average interest rate paid was 0% in 2018, 2017, and 2016.

(9) Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans or through standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments, whose contract amounts represent credit risk at December 31 of the indicated periods, were as follows:

	2018	2017
Undisbursed loan commitments	\$ 201,983	\$ 220,882
Standby letters of credit	2,974	2,635
Commitments to sell loans	570	1,283
	<u>\$ 205,527</u>	<u>\$ 224,800</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank issues both financial and performance standby letters of credit. The financial standby letters of credit are primarily to guarantee payment to third parties. At December 31, 2018, there were no financial standby letters of credit outstanding. The performance standby letters of credit are typically issued to municipalities as specific performance bonds. At December 31, 2018, there was \$2,974 issued in performance standby letters of credit and the Bank carried no liability. The Bank has experienced no draws on these letters of credit and does not expect to in the future; however, should a triggering event occur, the Bank either has collateral in excess of the letter of credit or imbedded agreements of recourse from the customer. The Bank has set aside a reserve for unfunded commitments in the amount of \$800 and \$850 at December 31, 2018 and 2017, respectively, which is recorded in "interest payable and other liabilities" on the consolidated balance sheets.

Commitments to extend credit and standby letters of credit bear similar credit risk characteristics as outstanding loans. As of December 31, 2018, the Company had no off-balance sheet derivatives requiring additional disclosure.

Mortgage loans sold to investors may be sold with servicing rights retained, for which the Company makes only standard legal representations and warranties as to meeting certain underwriting and collateral documentation standards. In the past two years, the Company has not had to repurchase any loans due to deficiencies in underwriting or loan documentation. Management believes that any liabilities that may result from such recourse provisions are not significant.

(10) Commitments and Contingencies

The Company is obligated for rental payments under certain operating lease agreements, some of which contain renewal options. Total rental expense for all leases included in net occupancy and equipment expense amounted to approximately \$878, \$868, and \$1,078 for the years ended December 31, 2018, 2017, and 2016, respectively. At December 31, 2018, the future minimum payments under non-cancelable operating leases with initial or remaining terms in excess of one year were as follows:

Year ending December 31:

2019	\$	872
2020		858
2021		802
2022		737
2023		669
Thereafter		1,389
	\$	<u>5,327</u>

At December 31, 2018, the aggregate maturities for time deposits were as follows:

Year ending December 31:

2019	\$	49,051
2020		8,343
2021		3,505
2022		1,863
2023		146
	\$	<u>62,908</u>

The Company is subject to various legal proceedings in the normal course of its business. In the opinion of management, after having consulted with legal counsel, the outcome of the pending legal proceedings should not have a material adverse effect on the consolidated financial condition or results of operations of the Company.

(11) Capital Adequacy and Restriction on Dividends

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's and the Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings, and other factors.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below).

In July 2013, the Federal Reserve Board and the other U.S. federal banking agencies adopted final rules making significant changes to the U.S. regulatory capital framework for U.S. banking organizations and to conform this framework to the guidelines published by the Basel Committee on Banking Supervision (Basel Committee) known as the Basel III Global Regulatory Framework for Capital and Liquidity. These rules adopted by the FRB and the other federal banking agencies (the U.S. Basel III Capital Rules) replaced the federal banking agencies' general risk-based capital rules, advanced approaches rule, market-risk rule, and leverage rules, in accordance with certain transition provisions. The Bank became subject to the new rules on January 1, 2015. The new rules implement higher minimum capital requirements, include a new common equity Tier 1 capital requirement, and establish criteria that instruments must meet in order to be considered common equity Tier 1 capital, additional Tier 1 capital, or Tier 2 capital. When fully phased in by January 1, 2019, the final rules will provide for increased minimum capital ratios as follows: (a) a common equity Tier 1 capital ratio of 4.5%; (b) a Tier 1 capital ratio of 6% (which is an increase from 4.0%); (c) a total capital ratio of 8%; and (d) a Tier 1 leverage ratio to average consolidated assets of 4%. Under the new rules, in order to avoid certain limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk based capital requirements (equal to 2.5% of total risk-weighted assets when fully phased in). The phase-in of the capital conservation buffer began on January 1, 2016, and must be completed by January 1, 2019. The U.S. Basel III Capital Rules also provide for various adjustments and deductions to the definitions of regulatory capital that phased in from January 1, 2014 through December 31, 2017.

Management believes, as of December 31, 2018, that the Bank met all capital adequacy requirements to which it is subject. As of December 31, 2018, the most recent notification from the Federal Deposit Insurance Corporation ("FDIC") categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must meet the minimum ratios as set forth below. As of the date hereof, there have been no conditions or events since that notification that management believes have changed the institution's category.

The Company and the Bank had Tier I Leverage, Common Equity Tier 1, Tier I Risk-Based and Total Risk-Based capital above the “well capitalized” levels at December 31, 2018 and 2017, respectively, as set forth in the following tables (calculated in accordance with the Basel III capital rules):

	The Company				Adequately Capitalized Ratio
	2018		2017		
	Capital	Ratio	Capital	Ratio	
Tier 1 Leverage Capital (to Average Assets)	\$ 117,497	9.3%	\$ 104,441	8.6%	4.0%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	117,497	13.5%	104,441	12.3%	4.5%
Tier 1 Capital (to Risk-Weighted Assets)	117,497	13.5%	104,441	12.3%	6.0%
Total Risk-Based Capital (to Risk-Weighted Assets)	128,442	14.7%	115,082	13.5%	8.0%

	The Bank				Adequately Capitalized Ratio	Well Capitalized Ratio
	2018		2017			
	Capital	Ratio	Capital	Ratio		
Tier 1 Leverage Capital (to Average Assets)	\$ 114,342	9.0%	\$ 101,631	8.4%	4.0%	5.0%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	114,342	13.1%	101,631	12.0%	4.5%	6.5%
Tier 1 Capital (to Risk-Weighted Assets)	114,342	13.1%	101,631	12.0%	6.0%	8.0%
Total Risk-Based Capital (to Risk-Weighted Assets)	125,287	14.4%	112,272	13.2%	8.0%	10.0%

Cash dividends declared by the Bank are restricted under California State banking laws to the lesser of the Bank’s retained earnings or the Bank’s net income for the latest three fiscal years, less dividends previously declared during that period.

(12) Fair Value Measurement

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale and trading securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a non-recurring basis, such as loans held-for-sale, loans held-for-investment and certain other assets. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally corresponds with the Company's quarterly valuation process.

Assets Recorded at Fair Value on a Recurring Basis

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017.

December 31, 2018	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities	\$ 50,682	\$ 50,682	\$ —	\$ —
Securities of U.S. government agencies and corporations	42,076	—	42,076	—
Obligations of states and political subdivisions	19,168	—	19,168	—
Collateralized mortgage obligations	63,799	—	63,799	—
Mortgage-backed securities	138,912	—	138,912	—
Total investments at fair value	\$ 314,637	\$ 50,682	\$ 263,955	\$ —

December 31, 2017	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities	\$ 18,464	\$ 18,464	\$ —	\$ —
Securities of U.S. government agencies and corporations	21,109	—	21,109	—
Obligations of states and political subdivisions	23,208	—	23,208	—
Collateralized mortgage obligations	66,083	—	66,083	—
Mortgage-backed securities	151,877	—	151,877	—
Total investments at fair value	\$ 280,741	\$ 18,464	\$ 262,277	\$ —

There were no transfers of assets measured at fair value on a recurring basis between level 1 and level 2 of the fair value hierarchy.

Assets Recorded at Fair Value on a Non-recurring Basis

Assets measured at fair value on a non-recurring basis are included in the table below by level within the fair value hierarchy as of December 31, 2018 and 2017.

December 31, 2018	Total	Level 1	Level 2	Level 3
Impaired loans	\$ 300	\$ —	\$ —	\$ 300
Other real estate owned	1,092	—	—	1,092
Total assets at fair value	\$ 1,392	\$ —	\$ —	\$ 1,392
December 31, 2017	Total	Level 1	Level 2	Level 3
Impaired loans	\$ 1,468	\$ —	\$ —	\$ 1,468
Total assets at fair value	\$ 1,468	\$ —	\$ —	\$ 1,468

There were no liabilities measured at fair value on a recurring or non-recurring basis at December 31, 2018 and 2017.

Key methods and assumptions used in measuring the fair value of impaired loans and other real estate owned as of December 31, 2018 and 2017 were as follows:

	Method	Assumption Inputs
Impaired loans	Collateral, market, income, enterprise, liquidation and discounted cash flows	External appraised values, management assumptions regarding market trends or other relevant factors, selling costs generally ranging from 6% to 10%, or the amount and timing of cash flows based on the loan's effective interest rate.
Other real estate owned	Collateral	External appraised values, management assumptions regarding market trends or other relevant factors, selling costs generally ranging from 6% to 10%.

The following section describes the valuation methodologies used for assets recorded at fair value.

Investment Securities Available-for-Sale

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, if available. If quoted market prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions, and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets where valuations include significant unobservable assumptions.

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, the Company measures impairment. The fair value of impaired loans is estimated using one of several methods, including the present value of expected cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Those impaired loans not requiring charge-off or specific allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

At December 31, 2018, certain impaired loans were considered collateral dependent and were evaluated based on the fair value of the underlying collateral securing the loan. Impaired loans where a charge-off is recorded based on the fair value of collateral require classification in the fair value hierarchy. When a loan is evaluated based on the fair value of the underlying collateral securing the loan, the Company records the impaired loan as non-recurring Level 3 given the valuation includes significant unobservable assumptions.

Other Real Estate Owned

Other real estate assets (“OREO”) acquired through, or in lieu of, foreclosure are held-for-sale and are initially recorded at the lower of cost or fair value, less selling costs. Any write-downs to fair value at the time of transfer to OREO are charged to the allowance for loan losses. Appraisals or evaluations are then done periodically thereafter charging any additional write-downs or valuation allowances to the appropriate expense accounts. Values are derived from appraisals of underlying collateral and discounted cash flow analysis. OREO is classified within Level 3 of the hierarchy given the valuation includes significant unobservable assumptions.

Disclosures about Fair Value of Financial Instruments

The following table summarizes fair value estimates for financial instruments for the years ended December 31, 2018 and 2017, excluding financial instruments recorded at fair value on a recurring basis (summarized in the first table in this note).

	Level	2018		2017	
		Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:					
Cash and cash equivalents	1	\$ 116,032	\$ 116,032	\$ 152,892	\$ 152,892
Certificates of deposit	2	7,595	7,573	1,984	1,983
Other equity securities	3	6,019	6,019	5,567	5,567
Loans receivable:					
Net loans	3	763,393	726,179	739,112	736,292
Loans held-for-sale	2	2,295	2,345	1,040	1,060
Interest receivable	2	4,158	4,158	4,117	4,117
Mortgage servicing rights	3	1,579	2,091	1,712	1,876
Financial liabilities:					
Deposits	3	1,124,612	966,464	1,104,740	993,425
Interest payable	2	74	74	72	72

Limitations

On January 1, 2018 the Company adopted ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which required the fair value of our loans held for investment, which is recorded at amortized cost, to incorporate the exit price notion. As a result, the fair value of loans held for investment as of December 31, 2018 is not comparable to the fair value of loans held for investment as of December 31, 2017.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument and expected exit prices. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company’s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial assets or liabilities include deferred tax liabilities and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in many of the estimates.

(13) Outstanding Shares and Earnings Per Share

All income per share amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019, to shareholders of record as of February 28, 2019.

Earnings Per Share

Basic and diluted earnings per share for the years ended December 31, were computed as follows:

	(in thousands, except per share amounts)		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Basic earnings per share:			
Net income	\$ <u>12,551</u>	\$ <u>8,748</u>	\$ <u>8,051</u>
Weighted average common shares outstanding	<u>12,123,801</u>	<u>12,082,983</u>	<u>12,058,728</u>
Basic earnings per share	\$ <u>1.04</u>	\$ <u>0.72</u>	\$ <u>0.67</u>
Diluted earnings per share:			
Net income	\$ <u>12,551</u>	\$ <u>8,748</u>	\$ <u>8,051</u>
Weighted average common shares outstanding	<u>12,123,801</u>	<u>12,082,983</u>	<u>12,058,728</u>
Effect of dilutive shares	<u>167,894</u>	<u>153,534</u>	<u>77,554</u>
Adjusted weighted average common shares outstanding	<u>12,291,695</u>	<u>12,236,517</u>	<u>12,136,282</u>
Diluted earnings per share	\$ <u>1.02</u>	\$ <u>0.71</u>	\$ <u>0.66</u>

Options not included in the computation of diluted earnings per share because they would have had an anti-dilutive effect amounted to 86,267 shares, 70,374 shares, and 168,311 shares for the years ended December 31, 2018, 2017, and 2016, respectively.

(14) Stock Compensation Plans

The Company has one stock option plan. Under the 2016 Stock Incentive Plan (the "Plan"), the Company may grant option grants, stock appreciation rights, restricted stock, or stock units to an employee for an amount up to 25,000 total shares in any calendar year. With respect to awards granted to non-employee directors under the Plan during the term of the Plan, the total number of shares of common stock which may be issued upon exercise or settlement of such awards is 100,000 shares and no outside director may receive option grants, stock appreciation rights, restricted stock or stock units for more than 3,000 shares total in any calendar year. There are 735,555 shares authorized under the 2016 Stock Incentive Plan. The total number of shares authorized has been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019. The 2016 Stock Incentive Plan will terminate on March 15, 2026.

The Compensation Committee of the Board of Directors is authorized to prescribe the terms and conditions of each option, including exercise price, vestings, or duration of the option. Generally, option grants vest at a rate of 25% per year after the first anniversary of the date of grant and restricted stock awards vest at a rate of 100% after four years. Options expire 10 years after the date of grant. Options are granted with an exercise price of the fair value of the related common stock on the date of grant.

Stock option activity for the Company's Stock Incentive Plan during the year ended December 31, 2018 is as follows:

	Stock Options	
	Number of shares	Weighted average exercise price
Balance at December 31, 2017	273,622	\$ 7.07
Granted	73,361	12.41
Exercised	(14,216)	6.71
Expired	(3,583)	11.33
Balance at December 31, 2018	<u>329,184</u>	<u>\$ 8.23</u>

All number of shares and weighted average exercise price amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019.

The following table presents information on stock options for the year ended December 31, 2018:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term
Options exercised	14,216	\$ 6.71	\$ 81	—
Stock options outstanding and expected to vest:	329,184	\$ 8.23	\$ 915	6.76
Stock options vested and currently exercisable:	162,233	\$ 6.02	\$ 744	5.26

The weighted average grant date fair value per share of options granted during the years ended December 31 was \$2.36 in 2018, \$2.55 in 2017, and \$1.88 in 2016. All weighted average grant date fair value per share amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019.

The intrinsic value of options exercised during the years ended December 31 was \$81 in 2018, \$0 in 2017 and \$37 in 2016. The fair value of awards vested during the years ended December 31 was \$114 in 2018, \$85 in 2017 and \$67 in 2016.

At December 31, 2018, the range of exercise prices for all outstanding options ranged from \$3.27 to \$12.41. The range of exercise prices have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019.

As of December 31, 2018, there was \$261 of total unrecognized compensation related to non-vested stock options. This cost is expected to be recognized over a weighted average period of approximately 2.4 years.

For the years ended December 31, 2018, 2017, and 2016 there was \$140, \$111, and \$85, respectively, of recognized compensation related to stock options.

The Company determines fair value at grant date using the Black-Scholes-Merton pricing model that takes into account the stock price at the grant date, the exercise price, the risk-free interest rate, the volatility of the underlying stock and the expected life of the option.

The weighted average assumptions used in the pricing model are noted in the following table. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on both the implied volatilities from the traded option on the Company's stock and historical volatility on the Company's stock.

The Company expenses the fair value of the option on a straight line basis over the vesting period. The Company estimates forfeitures and only recognizes expense for those shares that actually vest.

The following table shows our weighted average assumptions used in valuing stock options granted for the years ended December 31:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Risk-Free Interest Rate	2.57%	1.89%	1.23%
Expected Dividend Yield	0.00%	0.00%	0.00%
Expected Life in Years	5.00	5.00	5.00
Expected Price Volatility	14.44%	22.88%	28.41%

In addition to stock options, the Company also grants restricted stock awards to directors, certain officers and employees. The restricted shares awarded become fully vested after one to four years of continued employment or service from the date of grant. Restricted shares are forfeited if officers and employees terminate prior to the lapsing of restrictions.

The following table presents information about non-vested restricted stock awards outstanding for the year ended December 31, 2018:

	<u>Restricted Stock Awards</u>	
	<u>Number of shares</u>	<u>Weighted average grant date fair value</u>
Balance at December 31, 2017	117,440	\$ 7.48
Granted	27,057	12.41
Vested	(26,068)	5.95
Balance at December 31, 2018	<u>118,429</u>	<u>\$ 8.94</u>

All number of shares and weighted average grant date fair value amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019.

The aggregate intrinsic value of restricted stock awards vested in calendar year 2018, 2017, and 2016 was \$323, \$200, and \$141, respectively.

The weighted average fair value per share of restricted stock awards granted during the years ended December 31 was \$12.41 in 2018, \$10.53 in 2017, and \$6.89 in 2016. All weighted average grant date fair value per share amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019.

As of December 31, 2018, there was \$493 of total unrecognized compensation related to non-vested restricted stock awards. This cost is expected to be recognized over a weighted average period of approximately 2.5 years.

For the year ended December 31, 2018, 2017, and 2016, there was \$262, \$211, and \$177, respectively, of recognized compensation related to restricted stock awards.

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan ("ESPP"). Under the 2016 ESPP, the Company is authorized to issue to an eligible employee shares of common stock. There are 295,277 shares authorized under the 2016 ESPP, which include authorized but unissued shares under the 2006 Amended ESPP. The total number of shares authorized has been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019. The 2016 ESPP will expire on March 16, 2026.

The ESPP is implemented by participation periods of not more than twenty-seven months each. The Board of Directors determines the commencement date and duration of each participation period. An eligible employee is one who has been continually employed for at least ninety (90) days prior to commencement of a participation period. Under the terms of the Plan, employees can choose to have up to 10 percent of their compensation withheld to purchase the Company's common stock each participation period. The purchase price of the stock is 85 percent of the lower of the fair value on the last trading day before the Date of Participation or the fair value on the last trading day during the participation period. Approximately 30 percent of eligible employees are participating in the Plan in the current participation period, which began November 24, 2018 and will end November 23, 2019.

Under the Plan, at the annual stock purchase date of November 24, 2018, there were \$90 in contributions, and 8,863 shares were purchased at an average price of \$10.20. The total number of shares purchased and average price have been adjusted to give retroactive effect to the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019. For the year ended December 31, 2018, 2017, and 2016, there was \$22, \$56, and \$24, respectively, of recognized compensation related to ESPP issuances. Compensation cost is reported in salaries and employee benefits expense in the consolidated statements of income.

(15) Profit Sharing Plan

The Bank maintains a profit sharing plan for the benefit of its employees. Employees who have completed 12 months and 1,000 hours of service are eligible. Under the terms of this plan, a portion of the Bank's profits, as determined by the Board of Directors, will be set aside and maintained in a trust fund for the benefit of qualified employees. Contributions to the plan, included in salaries and employee benefits in the consolidated statements of income, were \$2,104, \$2,050 and \$1,525 in 2018, 2017, and 2016, respectively.

(16) Supplemental Compensation Plans

EXECUTIVE SALARY CONTINUATION PLAN

Pension Benefit Plans

The Company and the Bank maintain an unfunded non-contributory defined benefit pension plan (“Salary Continuation Plan”) and related split dollar plan for a select group of highly compensated employees. The plan provides defined annual benefit levels between \$50 and \$125 depending on responsibilities at the Bank. The retirement benefits are paid for 10 years following retirement at age 65. Reduced retirement benefits are available after age 55 and 10 years of service.

Eligibility to participate in the Salary Continuation Plan is limited to a select group of management or highly compensated employees of the Bank that are designated by the Board.

Additionally, the Company and the Bank adopted a supplemental executive retirement plan (“SERP”) in 2006. The SERP is intended to integrate the various forms of retirement payments offered to executives. There are currently three participants in the SERP.

The SERP benefit is calculated using 3-year average salary plus 7-year average bonus (average compensation). For each year of service, the benefit formula credits 2% - 2.5% of average compensation up to a cumulative maximum of 50%. Therefore, for an executive serving 20 - 25 years, the target benefit is 50% of average compensation.

The target benefit is reduced for other forms of retirement income provided by the Bank. Reductions are made for 50% of the social security benefit expected at age 65 and for the accumulated value of contributions the Bank makes to the executive’s profit sharing plan. For purposes of this reduction, contributions to the profit sharing plan are accumulated each year at a 3-year average of the yields on 10-year Treasury securities. Retirement benefits are paid monthly for 120 months, plus 6 months for each full year of service over 10 years, up to a maximum of 180 months.

Reduced benefits are payable for retirement prior to age 65. Should retirement occur prior to age 65, the benefit determined by the formula described above is reduced 5% for each year payments commence prior to age 65. Therefore, the new SERP benefit is reduced 50% for retirement at age 55. No benefit is payable for voluntary terminations prior to age 55.

The Bank uses a December 31 measurement date for these plans.

	For the Year Ended December 31,		
	2018	2017	2016
Change in benefit obligation			
Benefit obligation at beginning of year	\$ 5,419	\$ 4,523	\$ 4,261
Service cost	174	99	104
Interest cost	185	171	161
Plan loss (gain)	(184)	948	177
Benefits Paid	(272)	(322)	(180)
Benefit obligation at end of year	<u>\$ 5,322</u>	<u>\$ 5,419</u>	<u>\$ 4,523</u>
Change in plan assets			
Employer Contribution	272	322	180
Benefits Paid	(272)	(322)	(180)
Fair value of plan assets at end of year	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Reconciliation of funded status			
Funded status	\$ (5,322)	\$ (5,419)	\$ (4,523)
Unrecognized net plan loss	1,643	1,929	1,065
Unrecognized prior service cost	39	40	77
Net amount recognized	<u>\$ (3,640)</u>	<u>\$ (3,450)</u>	<u>\$ (3,381)</u>
Amounts recognized in the consolidated balance sheets consist of:			
Accrued benefit liability	\$ (5,322)	\$ (5,419)	\$ (4,523)
Accumulated other comprehensive loss	1,682	1,969	1,142
Net amount recognized	<u>\$ (3,640)</u>	<u>\$ (3,450)</u>	<u>\$ (3,381)</u>

The Company expects to recognize approximately \$89 of the unrecognized net actuarial loss and prior service cost as a component of net periodic benefit cost in 2019.

	For the Year Ended December 31,		
	2018	2017	2016
Components of net periodic benefit cost			
Service cost	\$ 174	\$ 99	\$ 104
Interest cost	185	171	161
Amortization of prior service cost	2	61	88
Recognized actuarial loss	101	58	50
Net periodic benefit cost	<u>462</u>	<u>389</u>	<u>403</u>

Additional Information

Minimum benefit obligation at year end	\$ 5,322	\$ 5,419	\$ 4,523
(Decrease) increase in minimum liability included in other comprehensive income (loss)	\$ (287)	\$ 827	\$ 40

Assumptions used to determine benefit obligations at December 31

	2018	2017	2016
Discount rate used to determine net periodic benefit cost for years ended December 31	3.40%	3.80%	3.80%
Discount rate used to determine benefit obligations at December 31	4.10%	3.40%	3.80%
Future salary increases	5.70%	5.20%	4.00%

Plan Assets

The Bank informally funds the liabilities of the Salary Continuation Plan through life insurance purchased on the lives of plan participants. This informal funding does not meet the definition of “plan assets” under pension accounting standards. Therefore, assets held for this purpose are not disclosed as part of the Salary Continuation Plan.

Cash Flows

Contributions and Estimated Benefit Payments

For unfunded plans, contributions to the Salary Continuation Plan are the benefit payments made to participants. The Bank paid \$272 in benefit payments during fiscal 2018. The following benefit payments, which reflect expected future service, are expected to be paid in future fiscal years:

Year ending December 31,	Pension Benefits
2019	\$ 272
2020	272
2021	276
2022	332
2023	332
2024-2028	1,824

Disclosure of settlements and curtailments:

There were no events during fiscal 2018 that would constitute a curtailment or settlement.

DIRECTORS' RETIREMENT PLAN

Pension Benefit Plans

On July 19, 2001, the Company and the Bank approved an unfunded non-contributory defined benefit pension plan ("Directors' Retirement Plan") and related split dollar plan for the directors of the Bank. The plan provides a retirement benefit equal to \$1 per year of service as a director, up to a maximum benefit amount of \$15. The retirement benefit is payable for ten years following retirement at age 65. Reduced retirement benefits are available after age 55 and ten years of service.

The Bank uses a December 31 measurement date for the Directors' Retirement Plan.

	For the Year Ended December 31,		
	2018	2017	2016
Change in benefit obligation			
Benefit obligation at beginning of year	\$ 856	\$ 830	\$ 816
Service cost	12	11	11
Interest cost	25	27	27
Plan loss (gain)	(37)	18	6
Benefits paid	(69)	(30)	(30)
Benefit obligation at end of year	<u>\$ 787</u>	<u>\$ 856</u>	<u>\$ 830</u>
Change in plan assets			
Employer contribution	\$ 69	\$ 30	\$ 30
Benefits paid	(69)	(30)	(30)
Fair value of plan assets at end of year	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Reconciliation of funded status			
Funded status	\$ (787)	\$ (856)	\$ (830)
Unrecognized net plan gain	(40)	(4)	(22)
Net amount recognized	<u>\$ (827)</u>	<u>\$ (860)</u>	<u>\$ (852)</u>
Amounts recognized in the statement of financial position consist of:			
Accrued benefit liability	\$ (787)	\$ (856)	\$ (830)
Accumulated other comprehensive income	(40)	(4)	(22)
Net amount recognized	<u>\$ (827)</u>	<u>\$ (860)</u>	<u>\$ (852)</u>

	For the Year Ended December 31,		
	2018	2017	2016
Components of net periodic benefit cost			
Service cost	\$ 12	\$ 11	\$ 11
Interest cost	25	27	27
Recognized actuarial gain	—	—	—
Net periodic benefit cost	<u>37</u>	<u>38</u>	<u>38</u>

Additional Information

Minimum benefit obligation at year end	\$ 787	\$ 856	\$ 830
(Decrease) increase in minimum liability included in other comprehensive income (loss)	\$ (36)	\$ 18	\$ 5

Assumptions used to determine benefit obligations at December 31

	2018	2017	2016
Discount rate used to determine net periodic benefit cost for years ended December 31	3.00%	3.30%	3.40%
Discount rate used to determine benefit obligations at December 31	3.70%	3.00%	3.30%

Plan Assets

The Bank informally funds the liabilities of the Directors' Retirement Plan through life insurance purchased on the lives of plan participants. This informal funding does not meet the definition of "plan assets" under pension accounting standards. Therefore, assets held for this purpose are not disclosed as part of the Directors' Retirement Plan.

Cash Flows

Contributions and Estimated Benefit Payments

For unfunded plans, contributions to the Directors' Retirement Plan are the benefit payments made to participants. The Bank paid \$69 in benefit payments during fiscal 2018. The following benefit payments, which reflect expected future service, are expected to be paid in future fiscal years:

Year ending December 31,	Pension Benefits
2019	\$ 60
2020	60
2021	75
2022	76
2023	75
2024-2028	374

Disclosure of settlements and curtailments:

There were no events during fiscal 2018 that would constitute a curtailment or settlement.

EXECUTIVE ELECTIVE DEFERRED COMPENSATION PLAN — 2001 EXECUTIVE DEFERRAL PLAN

On July 19, 2001, the Bank approved a revised Executive Elective Deferred Compensation Plan (“2001 Executive Deferral Plan”) for certain officers to provide them the ability to make elective deferrals of compensation due to tax law limitations on benefit levels under qualified plans. Deferred amounts earn interest at an annual rate determined by the Bank’s Board. The plan is a non-qualified plan funded with Bank owned life insurance policies taken on the lives of the participating officers. During the year ended December 31, 2001, the Bank purchased insurance making a single-premium payment aggregating \$1,125, which is reported in other assets on the Consolidated Balance Sheets. The Bank is the beneficiary and owner of the policies. The cash surrender value of the related insurance policies as of December 31, 2018 and 2017 totaled \$2,548 and \$2,484, respectively. The increase in accrued liability for the 2001 Executive Deferral Plan during the years ended December 31, 2018 and 2017 totaled \$12 and \$14, respectively. The expenses for the 2001 Executive Deferral Plan for the years ended December 31, 2018, 2017, and 2016 totaled \$12, \$14, and \$13, respectively.

DIRECTOR ELECTIVE DEFERRED FEE PLAN — 2001 DIRECTOR DEFERRAL PLAN

On July 19, 2001, the Bank approved a Director Elective Deferred Fee Plan (“2001 Director Deferral Plan”) for directors to provide them the ability to make elective deferrals of director's fees. Deferred amounts earn interest at an annual rate determined by the Bank’s Board. The plan is a non-qualified plan funded with Bank owned life insurance policies taken on the lives of the participating directors. The Bank is the beneficiary and owner of the policies. The cash surrender value of the related insurance policies as of December 31, 2018 and 2017 totaled \$140 and \$136, respectively. The increase in accrued liability for the 2001 Director Deferral Plan totaled \$1 during each of the years ended December 31, 2018 and 2017. The expenses for the 2001 Director Deferral Plan totaled \$1 for each of the years ended December 31, 2018, 2017, and 2016.

(17) Income Taxes

The provision for income tax expense consisted of the following for the years ended December 31:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Current:			
Federal	\$ 3,654	\$ 4,611	\$ 3,903
State	2,300	1,788	1,419
	<u>5,954</u>	<u>6,399</u>	<u>5,322</u>
Deferred:			
Federal	(711)	1,914	(354)
State	(499)	5	(83)
	<u>(1,210)</u>	<u>1,919</u>	<u>(437)</u>
	<u>\$ 4,744</u>	<u>\$ 8,318</u>	<u>\$ 4,885</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2018 and 2017 consisted of:

	<u>2018</u>	<u>2017</u>
Deferred tax assets:		
Allowance for loan losses	\$ 4,027	\$ 3,543
Deferred compensation	116	125
Retirement compensation	1,313	1,273
Stock option compensation	127	67
Postretirement benefits	472	565
Current state franchise taxes	470	381
Non-accrual interest	118	41
Low income housing tax credit partnership	128	—
Other	282	129
Sale-Leaseback	100	124
Investment securities unrealized loss	1,560	1,209
Deferred tax assets	<u>8,713</u>	<u>7,457</u>
Deferred tax liabilities:		
Fixed assets depreciation	1,478	1,461
FHLB dividends	187	187
Tax credit – loss on pass-through	—	176
Deferred loan costs	806	941
Mortgage servicing rights	142	129
Other	84	15
Total deferred tax liabilities	<u>2,697</u>	<u>2,909</u>
Net deferred tax assets (see Note 7)	<u>\$ 6,016</u>	<u>\$ 4,548</u>

Based upon the level of historical taxable income and projections for future taxable income over the periods during which the deferred tax assets are deductible, management believed it is more-likely-than-not the Company will realize the benefits of these deductible differences.

At December 31, 2018, the Company had no state net operating loss carry forwards and no federal tax credit carry forwards.

A reconciliation of income taxes computed at the federal statutory rate and the provision for income taxes for the years ended December 31, 2018, 2017 and 2016 is as follows:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Federal statutory income tax rate	21.0 %	34.0 %	34.0 %
Increase (decrease) in tax rate due to:			
State franchise tax, net of federal benefit	8.2%	6.9%	6.8%
Reduction for tax exempt interest	(0.8)%	(0.6)%	(0.9)%
Cash surrender value of life insurance	(0.5)%	(0.9)%	(1.2)%
Tax rate change	0.0%	9.8%	0.0%
Other tax credits	(0.5)%	(1.1)%	(1.1)%
Other	0.0%	0.6%	0.1%
	<u>27.4%</u>	<u>48.7%</u>	<u>37.7%</u>
Effective income tax rate			

Accounting for Uncertainty in Income Taxes

The Company had no unrecognized tax benefits for the years ended December 31, 2018 and December 31, 2017, respectively. The Company recognized a change in unrecognized tax benefits during 2018 and 2017 of \$0 and \$5 due to the expiration of a statute of limitations and other gross decreases. The Company had no significant uncertain tax positions as of December 31, 2018. The Company does not anticipate any significant increase or decrease in unrecognized tax benefits during 2019.

The Company classifies interest and penalties as a component of the provision for income taxes. At December 31, 2018, there were no unrecognized interest and penalties. The tax years ended December 31, 2017, 2016, and 2015 remain subject to examination by the Internal Revenue Service. The tax years ended December 31, 2017, 2016, 2015, and 2014 remain subject to examination by the California Franchise Tax Board. The deductibility of these tax positions will be determined through examination by the appropriate tax authorities or the expiration of the tax statute of limitations.

(18) Accumulated Other Comprehensive Income/(Loss)

The following table details activity in accumulated other comprehensive income (loss) for the year ended December 31, 2018.

	Unrealized Gains (Losses) on Securities	Officers' retirement plan	Directors' retirement plan	Accumulated Other Comprehensive Income/(loss)
Balance as of December 31, 2017	\$ (2,997)	\$ (1,403)	\$ 3	\$ (4,397)
Current period other comprehensive income (loss), net of tax	(870)	205	26	(639)
Balance as of December 31, 2018	<u>\$ (3,867)</u>	<u>\$ (1,198)</u>	<u>\$ 29</u>	<u>\$ (5,036)</u>

The following table details activity in accumulated other comprehensive income/(loss) for the year ended December 31, 2017.

	Unrealized Gains (Losses) on Securities	Officers' retirement plan	Directors' retirement plan	Accumulated Other Comprehensive Income/(loss)
Balance as of December 31, 2016	\$ (1,678)	\$ (686)	\$ 14	\$ (2,350)
Current period other comprehensive income (loss), net of tax	(846)	(591)	(11)	(1,448)
Tax rate change reclassification	(473)	(126)	—	(599)
Balance as of December 31, 2017	<u>\$ (2,997)</u>	<u>\$ (1,403)</u>	<u>\$ 3</u>	<u>\$ (4,397)</u>

The following table details activity in accumulated other comprehensive income/(loss) for the year ended December 31, 2016.

	Unrealized Gains (Losses) on Securities	Officers' retirement plan	Directors' retirement plan	Accumulated Other Comprehensive Income/(loss)
Balance as of December 31, 2015	\$ 150	\$ (662)	\$ 17	\$ (495)
Current period other comprehensive (loss) income, net of tax	(1,828)	(24)	(3)	(1,855)
Balance as of December 31, 2016	<u>\$ (1,678)</u>	<u>\$ (686)</u>	<u>\$ 14</u>	<u>\$ (2,350)</u>

(19) Supplemental Consolidated Statements of Cash Flows Information

Supplemental disclosures to the Consolidated Statements of Cash Flows for the years ended December 31, are as follows:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 1,266	\$ 1,085	\$ 1,152
Income taxes	\$ 4,105	\$ 7,265	\$ 5,450
Supplemental disclosure of non-cash investing and financing activities:			
Stock dividend distributed	\$ 6,046	\$ 5,295	\$ 3,351
Fair value adjustment of securities available for sale, net of tax of \$(349), \$(564), and \$(1,218) for the years ended December 31, 2018, 2017, and 2016, respectively	\$ (870)	\$ (846)	\$ (1,828)
Loans held-for-investment transferred to other real estate owned	\$ 1,092	\$ —	\$ 217
Tax deficiency related to expired, vested non-qualified stock options	\$ —	\$ —	\$ (114)

(20) Parent Company Financial Information

This information should be read in conjunction with the other notes to the consolidated financial statements. The following presents summary balance sheets and summary statements of income and cash flows information for the years ended December 31:

Balance Sheets		2018	2017	
Assets				
Cash		\$ 3,155	\$ 2,810	
Investment in wholly owned subsidiary		109,306	97,234	
Total assets		<u>\$ 112,461</u>	<u>\$ 100,044</u>	
Liabilities and stockholders' equity				
Liabilities		—	—	
Stockholders' equity		112,461	100,044	
Total liabilities and stockholders' equity		<u>\$ 112,461</u>	<u>\$ 100,044</u>	
Statements of Income		2018	2017	2016
Dividends from subsidiary		\$ —	\$ —	\$ —
Other operating expenses		(226)	(224)	(203)
Income tax benefit		66	92	88
Loss before undistributed earnings of subsidiary		(160)	(132)	(115)
Equity in undistributed earnings of subsidiary		12,711	8,880	8,166
Net income		<u>\$ 12,551</u>	<u>\$ 8,748</u>	<u>\$ 8,051</u>
Statements of Cash Flows		2018	2017	2016
Net income		\$ 12,551	\$ 8,748	\$ 8,051
Adjustments to reconcile net income to net cash provided by operating activities				
Stock plan accruals		424	378	286
Equity in undistributed earnings of subsidiary		(12,711)	(8,880)	(8,166)
Net cash provided by operating activities		264	246	171
Cash flows from financing activities:				
Common stock issued		91	78	61
Stock options exercised		—	—	25
Cash in lieu of fractional shares		(10)	(10)	(5)
Net cash provided by financing activities		81	68	81
Net change in cash		345	314	252
Cash at beginning of year		2,810	2,496	2,244
Cash at end of year		<u>\$ 3,155</u>	<u>\$ 2,810</u>	<u>\$ 2,496</u>

(21) Related Party Transactions

The Bank, in the ordinary course of business, has loan and deposit transactions with directors and executive officers. In management's opinion, these transactions were on substantially the same terms as comparable transactions with other customers of the Bank. The amount of such deposits totaled approximately \$5,186, \$5,283 and \$5,858 at December 31, 2018, 2017, and 2016, respectively.

The following is an analysis of the activity of loans to executive officers and directors for the years ended December 31:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Outstanding balance, beginning of year	\$ 2,472	\$ 2,373	\$ 2,340
Credit granted	1,682	3,014	4,970
Repayments / Reductions	<u>(2,425)</u>	<u>(2,915)</u>	<u>(4,937)</u>
Outstanding balance, end of year	<u>\$ 1,729</u>	<u>\$ 2,472</u>	<u>\$ 2,373</u>

ITEM 9 - CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A – CONTROLS AND PROCEDURES

Disclosure controls and procedures

The Company maintains “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934 (“Exchange Act”), that are designed to ensure that information required to be disclosed in reports that the Company files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management, including the Company’s chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. The Company’s disclosure controls and procedures have been designed to meet and management believes that they meet reasonable assurance standards. Based on their evaluation as of the end of the period covered by this Annual Report on Form 10-K, the chief executive officer and chief financial officer have concluded that the Company’s disclosure controls and procedures were effective to ensure that material information relating to the Company, including its consolidated subsidiary, is made known to them by others within those entities.

Internal controls over financial reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system has been designed to provide reasonable assurance to the Company’s management and Board of Directors regarding the preparation and fair presentation of the Company’s published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. As required by Rule 13a-15(d), management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the period covered by this Annual Report on Form 10-K that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that there has been no such change during the last quarter of the fiscal year covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting. See “Management’s Report” included in Item 8 for management’s report on the adequacy of internal control over financial reporting.

ITEM 9B – OTHER INFORMATION

None.

PART III

ITEM 10 – DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE

The information called for by this item with respect to director and executive officer information is incorporated by reference herein from the sections of the Company’s proxy statement for its 2019 Annual Meeting of Shareholders entitled “Executive Officers,” “Security Ownership of Certain Beneficial Owners and Management,” “Executive Compensation” “Report of Audit Committee,” “Section 16(a) Beneficial Ownership Compliance” and “Nomination and Election of Directors.”

The Company has adopted a Code of Conduct, which complies with the Code of Ethics requirements of the Securities and Exchange Commission. A copy of the Code of Conduct is posted on the “Investor Relations” page of the Company’s website, or is available, without charge, upon the written request of any shareholder directed to Devon Camara-Soucy, Corporate Secretary, First Northern Community Bancorp, 195 North First Street, Dixon, California 95620. The Company intends to disclose promptly any amendment to, or waiver from any provision of, the Code of Conduct applicable to senior financial officers, and any waiver from any provision of the Code of Conduct applicable to directors, on the “Investor Relations” page of its website.

The Company’s website address is www.thatsmybank.com.

ITEM 11 - EXECUTIVE COMPENSATION

The information called for by this item is incorporated by reference herein from the sections of the Company’s proxy statement for its 2019 Annual Meeting of Shareholders entitled “Nomination and Election of Directors,” “Transactions with Related Persons,” “Director Compensation,” and “Executive Compensation.”

ITEM 12 - SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information concerning ownership of the equity stock of the Company by certain beneficial owners and management is incorporated herein by reference from the sections of the Company's proxy statement for the 2019 Annual Meeting of Shareholders entitled "Security Ownership of Certain Beneficial Owners and Management" and "Nomination and Election of Directors."

Stock Purchase Equity Compensation Plan Information

The following table shows the Company's equity compensation plans approved by security holders. The table also indicates the number of securities to be issued upon exercise of outstanding options, weighted-average exercise price of outstanding options, non-vested restricted stock and the number of securities remaining available for future issuance under the Company's equity compensation plans as of December 31, 2018. All amounts have been adjusted to give retroactive effect to stock dividends and stock splits, including the 5% stock dividend declared on January 24, 2019, payable March 29, 2019 to shareholders of record as of February 28, 2019. The plans included in this table are the Company's 2006 Stock Incentive Plan and 2016 Stock Incentive Plan. See "Stock Compensation Plans" in Note 14 of Notes to Consolidated Financial Statements included in this Report.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities to be issued upon vesting of restricted stock	Weighted-average grant date fair value of restricted stock	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by security holders	329,184	\$ 8.23	118,429	\$ 8.94	444,331
Equity compensation plans not approved by security holders	—	—	—	—	—
Total	329,184	\$ 8.23	118,429	\$ 8.94	444,331

ITEM 13 - CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information called for by this item is incorporated herein by reference from the sections of the Company's proxy statement for its 2019 Annual Meeting of Shareholders entitled "Director Independence" and "Transactions with Related Persons."

ITEM 14 – PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information called for by this item is incorporated herein by reference from the section of the Company's proxy statement for its 2019 Annual Meeting of Shareholders entitled "Audit and Non-Audit Fees."

PART IV

ITEM 15 – EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements:

Reference is made to the Index to Financial Statements under Item 8 in Part II of this Form 10-K.

(a)(2) Financial Statement Schedules:

All schedules to the Company's Consolidated Financial Statements are omitted because of the absence of the conditions under which they are required or because the required information is included in the Consolidated Financial Statements or accompanying notes.

(a)(3) Exhibits:

The following is a list of all exhibits filed as part of this Annual Report on Form 10-K:

<u>Exhibit Number</u>	<u>Exhibit</u>
3.1	Amended Articles of Incorporation of the Company – provided herewith
3.2	Amended and Restated Bylaws of the Company (as amended) – provided herewith
10.1	First Northern Community Bancorp 2000 Stock Option Plan – incorporated herein by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-8 dated May 25, 2000*
10.2	First Northern Community Bancorp Outside Directors 2000 Non-statutory Stock Option Plan – incorporated herein by reference to Exhibit 4.3 of the Company's Registration Statement dated Form S-8 on May 25, 2000*
10.3	Amended First Northern Community Bancorp Employee Stock Purchase Plan – incorporated herein by reference to Appendix B of the Company's Definitive Proxy Statement on Schedule 14A for its 2006 Annual Meeting of Shareholders*
10.4	First Northern Community Bancorp 2000 Stock Option Plan Forms "Incentive Stock Option Agreement" and "Notice of Exercise of Stock Option" – incorporated herein by reference to Exhibit 4.2 of the Company's Registration Statement on Form S-8 dated May 25, 2000*
10.5	First Northern Community Bancorp 2000 Outside Directors 2000 Non-statutory Stock Option Plan Forms "Non-statutory Stock Option Agreement" and "Notice of Exercise of Stock Option" – incorporated herein by reference to Exhibit 4.4 of the Company's Registration Statement on Form S-8 dated May 25, 2000*
10.6	First Northern Community Bancorp 2000 Employee Stock Purchase Plan Forms "Participation Agreement" and "Notice of Withdrawal" – incorporated herein by reference to Exhibit 4.6 of the Company's Registration Statement on Form S-8 dated May 25, 2000*
10.7	Amended and Restated Employment Agreement entered into as of July 23, 2001 by and between First Northern Bank of Dixon and Don Fish – incorporated herein by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001*
10.8	Employment Agreement entered into as of July 23, 2001 by and between First Northern Bank of Dixon and Owen J. Onsum – incorporated herein by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001*

- 10.9 [Employment Agreement for Louise A. Walker, President and Chief Executive Officer](#) – incorporated herein by reference to Exhibit 10.1 of the Company’s Quarterly Report on Form 10-Q for the three months ended June 30, 2012*
- 10.10 [Employment Agreement entered into as of July 23, 2001 by and between First Northern Bank of Dixon and Robert Walker](#) – incorporated herein by reference to Exhibit 10.4 of the Company’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001*
- 10.11 [Form of Director Retirement and Split Dollar Agreements between First Northern Bank of Dixon and Lori J. Aldrete, Frank J. Andrews Jr., John M. Carbahal, Gregory DuPratt, John F. Hamel, Diane P. Hamlyn, Foy S. McNaughton, William Jones, Jr. and David Schulze](#) – incorporated herein by reference to Exhibit 10.11 to Company’s Annual Report on Form 10-K for the year ended December 31, 2001*
- 10.12 [Form of Salary Continuation and Split Dollar Agreement between First Northern Bank of Dixon and Owen J. Onsum, Louise A. Walker, Don Fish, and Robert Walker](#) – incorporated herein by reference to Exhibit 10.12 to Company’s Annual Report on Form 10-K for the year ended December 31, 2001*
- 10.13 [Amended Form of Director Retirement and Split Dollar Agreements between First Northern Bank of Dixon and Lori J. Aldrete, Frank J. Andrews Jr., John M. Carbahal, Gregory DuPratt, John F. Hamel, Diane P. Hamlyn, Foy S. McNaughton, William Jones, Jr. and David Schulze](#) – incorporated herein by reference to Exhibit 10.13 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2004*
- 10.14 [Amended Form of Salary Continuation and Split Dollar Agreement between First Northern Bank of Dixon and Owen J. Onsum, Louise A. Walker, Don Fish, and Robert Walker](#) – incorporated herein by reference to Exhibit 10.14 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2004*
- 10.15 [Form of Salary Continuation Agreement between Pat Day and First Northern Bank of Dixon](#) – incorporated herein by reference to Exhibit 10.15 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2006*
- 10.16 [Form of Supplemental Executive Retirement Plan Agreement between First Northern Bank of Dixon and Owen J. Onsum and Louise A. Walker](#) – incorporated herein by reference to Exhibit 10.16 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2006*
- 10.17 [First Northern Bancorp 2006 Stock Incentive Plan](#) – incorporated by reference to Appendix A of the Company’s Definitive Proxy Statement on Schedule 14A for its 2006 Annual Meeting of Shareholders*
- 10.18 [First Northern Bank Annual Incentive Compensation Plan](#) – incorporated herein by reference to Exhibit 10.18 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2006*
- 10.20 [First Northern Community Bancorp 2006 Stock Option Plan Forms “Stock Option Agreement” and “Notice of Exercise of Stock Option”](#) incorporated herein by reference to Exhibit 10.20 to the Company’s Annual Report for the year ended December 31, 2009 *
- 10.21 [First Northern Community Bancorp 2006 Stock Incentive Plan “Restricted Stock Agreement](#) incorporated by reference to Exhibit 10.21 to the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2009 *
- 10.22 [Employment Agreement for Jeremiah Z. Smith, Executive Vice President and Chief Financial Officer](#) - incorporated herein by reference to Exhibit 10.2 to the Company’s Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2012*
- 10.23 [Employment Agreement for Patrick S. Day, Executive Vice President and Chief Credit Officer](#) - incorporated herein by reference to Exhibit 10.3 to the Company’s Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2012*
- 10.24 [First Northern Bancorp 2016 Stock Incentive Plan](#) – incorporated by reference to Appendix A of the Company’s Definitive Proxy Statement on Schedule 14A for its 2015 Annual Meeting of Shareholders*.
- 10.25 [First Northern Bancorp 2016 Employee Stock Purchase Plan](#) – incorporated by reference to Appendix B of the Company’s Definitive Proxy Statement on Schedule 14A for its 2015 Annual Meeting of Shareholders*.
- 10.26 [Amended and Restated Executive Deferral Plan of First Northern Bank effective July 20, 2017](#) – incorporated herein by reference to Exhibit 10.26 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended September 30, 2017*

- 10.27 [Executive Retirement/Retention Participation Agreement for Joe Danelson, Executive Vice President and Chief Credit Officer](#) – incorporated herein by reference to Exhibit 10.27 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended September 30, 2017*
- 10.28 [Executive Retirement/Retention Participation Agreement for Jeremiah Z. Smith, Senior Executive Vice President and Chief Financial Officer & Chief Operating Officer](#) – incorporated herein by reference to Exhibit 10.28 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended September 30, 2017*
- 10.29 [Form of Supplemental Executive Retirement Plan Agreement between First Northern Bank of Dixon and Jeremiah Z. Smith, Senior Executive Vice President and Chief Operating Officer](#) – incorporated herein by reference to Exhibit 10.29 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 10.30 [Form of Supplemental Executive Retirement Plan Agreement between First Northern Bank of Dixon and Kevin Spink, Executive Vice President and Chief Financial Officer.](#) – incorporated herein by reference to Exhibit 10.30 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 10.31 [Change of Control Agreement between First Northern Bank of Dixon and Joe Danelson, Executive Vice President and Chief Credit Officer.](#) – incorporated herein by reference to Exhibit 10.31 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 10.32 [Change of Control Agreement between First Northern Bank of Dixon and Jeffrey Adamski, Executive Vice President and Senior Loan Officer.](#) – incorporated herein by reference to Exhibit 10.32 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 10.33 [Executive Retirement/Retention Participation Agreement for Jeffrey Adamski, Executive Vice President and Senior Loan Officer.](#) – incorporated herein by reference to Exhibit 10.33 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 10.34 [Amended Form of Salary Continuation Agreement between First Northern Bank of Dixon and Bruce Orris, Executive Vice President and Chief Information Officer.](#) – incorporated herein by reference to Exhibit 10.34 of the Company’s Quarterly Report on Form 10-Q for the quarter-ended March 31, 2018*
- 21.1 [Subsidiary of the Company – provided herewith](#)
- 23.1 [Consent of independent registered public accounting firm – provided herewith](#)
- 31.1 [Rule 13\(a\) – 14\(a\) / 15\(d\) – 14\(a\) Certification of the Company’s Chief Executive Officer – provided herewith](#)
- 31.2 [Rule 13\(a\) – 14\(a\) / 15\(d\) – 14\(a\) Certification of the Company’s Chief Financial Officer – provided herewith](#)
- 32.1** [Section 1350 Certification of the Chief Executive Officer – provided herewith](#)
- 32.2** [Section 1350 Certification of the Chief Financial Officer – provided herewith](#)
- 101 Pursuant to Rule 405 of Regulation S-T, the following financial information from the Registrant’s Annual Report on Form 10-K for the twelve months ended December 31, 2018, is formatted in XBRL interactive data files: (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Operations; (iii) Consolidated Statement of Comprehensive Income; (iv) Consolidated Statements of Stockholders’ Equity; (v) Consolidated Statements of Cash Flows; and (vi) Notes to Consolidated Financial Statements.

* Management contract or compensatory plan, contract or arrangement.

** In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-K and will not be deemed “filed” for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act.

ITEM 16 – FORM 10-K SUMMARY

Not applicable.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 8, 2019.

FIRST NORTHERN COMMUNITY BANCORP

By: /s/ Louise A. Walker

Louise A. Walker
President/Chief Executive Officer/Director
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
<u>/s/ Louise A. Walker</u> Louise A. Walker	President/Chief Executive Officer/Director (Principal Executive Officer)	<u>March 8, 2019</u>
<u>/s/ Jeremiah Z. Smith</u> Jeremiah Z. Smith	Senior Executive Vice President/Chief Operating Officer (Principal Operating Officer)	<u>March 8, 2019</u>
<u>/s/ Kevin Spink</u> Kevin Spink	Executive Vice President/Chief Financial Officer (Principal Financial Officer)	<u>March 8, 2019</u>
<u>/s/ FRANK J. ANDREWS, JR.</u> Frank J. Andrews, Jr.	Director	<u>March 8, 2019</u>
<u>/s/ PATRICK R. BRADY</u> Patrick R. Brady	Director	<u>March 8, 2019</u>
<u>/s/ JOHN M. CARBAHAL</u> John M. Carbahal	Director	<u>March 8, 2019</u>
<u>/s/ GREGORY DUPRATT</u> Gregory DuPratt	Director and Vice Chairman of the Board	<u>March 8, 2019</u>
<u>/s/ BARBARA HAYES</u> Barbara Hayes	Director	<u>March 8, 2019</u>
<u>/s/ RICHARD M. MARTINEZ</u> Richard M. Martinez	Director and Chairman of the Board	<u>March 8, 2019</u>
<u>/s/ FOY S. MCNAUGHTON</u> Foy S. McNaughton	Director	<u>March 8, 2019</u>
<u>/s/ SEAN P. QUINN</u> Sean P. Quinn	Director	<u>March 8, 2019</u>
<u>/s/ MARK C. SCHULZE</u> Mark C. Schulze	Director	<u>March 8, 2019</u>

AMENDED ARTICLES OF INCORPORATION

OF FIRST NORTHERN COMMUNITY BANCORP,

a California Corporation

ARTICLE 1

The name of the corporation is First Northern Community Bancorp.

ARTICLE 2

The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code.

ARTICLE 3

The name in the State of California of the corporation's initial agent for service of process is:

CT Corporation System

ARTICLE 4

The Corporation is authorized to issue two classes of shares to be designated respectively Common Stock ("Common Stock") and Preferred Stock ("Preferred Stock"). The total number of shares of all classes of capital stock that the Corporation is authorized to issue is Sixteen Million, Forty Thousand, Two Hundred and Thirty-Eight (16,040,238) shares. The total number of shares of Common Stock, without par value, the Corporation shall have authority to issue is Sixteen Million (16,000,000). The total number of shares of Preferred Stock, the Corporation shall have authority to issue shall be Forty Thousand, Two Hundred and Thirty-Eight (40,238), consisting of Seventeen Thousand, Three Hundred and Ninety (17,390) shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share, and Twenty-Two Thousand Eight Hundred and Forty-Eight (22,848) shares of Preferred Stock, without par value per share. The Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share, was issued by the Corporation on March 13, 2009 for purposes of permitting the Corporation to participate in the Capital Purchase Program instituted as part of the United States Department of Treasury's Troubled Asset Relief Program pursuant to the Emergency Economic Stabilization Act of 2008 and shall not be available for reissuance for any other purpose. The Board of Directors is hereby authorized from time to time in one or more series or classes to provide by resolution for the issuance of up to Twenty-Two Thousand Eight Hundred and Forty-Eight (22,848) shares of Preferred Stock, no par value per share, to participate in the United States Department of Treasury's Small Business Lending Fund instituted under the United States Small Business Jobs Act of 2010. Subject to the foregoing restrictions, and to the extent not prohibited by law, the Board of Directors is authorized: (i) to fix the number of shares of any series or class of Preferred Stock and to determine the designation of any such series or class, (ii) to determine or alter the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued series or class of Preferred Stock, including but not limited to rights, preferences, privileges, and restrictions regarding dividends, liquidation, conversion, redemption and voting (including provisions specifying more than one vote per share) and, (iii) within the limits and restrictions stated in any resolution or resolutions of the Board of Directors originally fixing the number of shares constituting any series or class, to increase or decrease (but not below the number of shares of such series then outstanding) the number of shares of any such series or class subsequent to the issue of shares of that series or class.

ARTICLE 5

Except as specified hereinbelow, each holder of Common Stock of the corporation shall have full preemptive rights, as defined by law, to subscribe for or purchase such holder's proportionate share of any Common Stock that may be offered for sale or sold at any time by the corporation. The Board of Directors shall have the power to prescribe a reasonable period of time within which the preemptive rights to subscribe to the new shares of Common Stock must be exercised. The foregoing right shall not apply to the sale or issuance by the corporation of additional shares of Common Stock (i) in connection with the acquisition by the corporation of another entity or business segment of any such entity by merger, purchase of all or substantially all the assets or other type of acquisition transaction; (ii) pursuant to any stock option, stock purchase or other stock plan, agreement or arrangement previously approved by the corporation's shareholders; (iii) in a public offering provided that the terms of the offering include a requirement that if the offering is over-subscribed, shares will be allocated on a pro rata basis based on actual paid subscriptions received by the corporation; or (iv) pursuant to corporation's participating the Capital Purchase Program, or otherwise in connection with the Capital Purchase Program.

ARTICLE 6

6.1 In addition to any affirmative vote required by law or these Articles of Incorporation, and except as otherwise expressly provided in Section 6.2 of this Article 6, any "Business Combination" (as hereinafter defined), which shall be consummated at a time when there shall exist an "Interested Shareholder" (as hereinafter defined), shall require the affirmative vote of the holders of at least sixty-six and two thirds percent (66 2/3%) of the then outstanding shares of Common Stock of this corporation entitled to vote. Such affirmative vote shall be required notwithstanding the fact that no vote may be required or that a lesser percentage may be specified by law or otherwise.

In addition to the higher vote requirement, except as otherwise expressly provided in Section 6.2 of this Article 6, prior to affecting any such Business Combination all of the following conditions shall have been met:

6.1.1 The aggregate amount of the cash and the "Fair Market Value" (as hereinafter defined) as of the date of the consummation of the Business Combination of consideration other than cash to be received per share by holders of the Common Stock in such Business Combination shall be at least equal to the higher of the following:

6.1.1.1 (if applicable) The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the Interested Shareholder for any shares of the Common Stock acquired by it (a) within the two-year period immediately prior to the first public announcement of the proposal of the Business Combination (the "Announcement Date") or (b) in the transaction in which it became an Interested Shareholder, if within two years of the Announcement Date, whichever is higher; and

6.1.1.2 The Fair Market Value per share of the Common Stock on the Announcement Date or on the date on which the Interested Shareholder became an Interested Shareholder the ("Determination Date"), if within two years of the Announcement Date, whichever is higher.

6.1.2 The consideration to be received by holders of the Common Stock shall be in cash or in the same form as the Interested Shareholder has previously paid for shares of the Common Stock. The price determined in accordance with Section 6.1.1 shall be subject to appropriate adjustment in the event of any stock dividend, stock split, combination of shares or similar event.

6.1.3 After such shareholder has become an Interested Shareholder and prior to the consummation of such Business Combination and except to the extent that the corporation may be prohibited by law from making a distribution to shareholders: (1) there shall have been (a) no reduction in the annual rate of dividends paid on the Common Stock of this corporation (except as necessary to reflect any subdivision of the Common Stock), except as approved by at least sixty-six and two-thirds percent (66 2/3%) of the "Disinterested Directors" (as hereinafter defined), and (b) an increase in such annual rate of dividends as necessary to reflect any reclassification (including any reverse stock split), recapitalization, reorganization or any similar transaction which has the effect of reducing the number or outstanding shares of the Common Stock, unless the failure so to increase such annual rate is approved by at least sixty-six and two-thirds percent (66 2/3%) of the Disinterested Directors; and (3) such Interested Shareholder shall have not become the beneficial owner of any additional shares of stock of this corporation except as part of the transaction which results in such shareholder becoming an Interested Shareholder within the two-year period prior to such consummation.

6.1.4 After such shareholder has become an Interested Shareholder, such Interested Shareholder shall not have received the benefit, directly or indirectly (except proportionately as a shareholder), of any loans, advances, guarantees, pledges or other financial assistance or any tax credits or other tax advantages provided by this corporation or any "Subsidiary" (as hereinafter defined), whether in anticipation of or in connection with such Business Combination or otherwise.

6.1.5 A proxy or information statement describing the proposed Business Combination and complying with the requirements of the Securities Exchange Act of 1934 and the rules and regulations thereunder (or any subsequent provisions replacing such Act, rules or regulations) shall be mailed to all holders of the Common Stock of this corporation at least 30 days prior to the consummation of such Business Combination (whether or not such proxy or information statement is required to be mailed pursuant to such Act or subsequent provisions).

6.2 The provisions of Section 6.1 of this Article 6 shall not be applicable to any particular Business Combination, and such Business Combination shall require only such affirmative vote as is required by law and any other provision of these Articles of Incorporation, if the Business Combination shall have been approved by at least sixty-six and two-thirds percent (66 2/3%) of the Disinterested Directors; or, if either

6.2.1 there is pending any proceeding or other action by the Federal Deposit Insurance Corporation pursuant to ss. 1818(a) or ss. 1823(c) of Title 12 of the United States Code in connection with any of the banking subsidiaries of the corporation; or

6.2.2 there is outstanding any order of the Commissioner of Financial Institutions of the State of California pursuant to California Financial Code ss.ss. 3100-3132 or ss.ss. 3180-3187 against any banking subsidiary of the corporation, or any other provision of similar purpose as hereinafter adopted and as the same may be amended at a future time.

6.3 For the purposes of this Article 6 the following definitions apply:

6.3.1 A "person" means any individual, firm, corporation or other entity.

6.3.2 "Interested Shareholder" means any person (other than this corporation or any Subsidiary) who or which:

6.3.2.1 is the beneficial owner, directly or indirectly, of ten percent (10%) or more of the issued and outstanding stock of this corporation; or

6.3.2.2 is an "Affiliate" of this corporation and at any time within the two-year period immediately prior to the date in question was the beneficial owner, directly or indirectly, of ten percent (10%) or more of the issued and outstanding stock of this corporation; or

6.3.2.3 is an assignee of or has otherwise succeeded to any shares of stock of this Corporation which were at any time within the two-year period immediately prior to the date in question beneficially owned by any Interested Shareholder, if such assignment or succession shall have occurred in the course of a transaction or series of transactions not involving a public offering within the meaning of the Securities Act of 1933.

6.3.3 A person shall be a "beneficial owner" of stock of this corporation:

6.3.3.1 which such person or any of its Affiliates or Associates (as hereinafter defined) beneficially owns, directly or indirectly; or

6.3.3.2 which such person or any of its Affiliates or Associates has (a) the right to acquire (whether such right is exercisable immediately or only after the passage of time), pursuant to any agreement, arrangement or understanding or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise, or (b) the right to vote pursuant to any agreement, arrangement or understanding; or

6.3.3.3 which are beneficially owned, directly or indirectly, by any other person with which such person or any of its Affiliates or Associates has any agreement, arrangement or understanding for the purpose of acquiring, holding, voting or disposing of any shares of stock of this corporation.

6.3.4 "Business Combination" shall include:

6.3.4.1 any merger or consolidation of the corporation or any Subsidiary with (i) any Interested Shareholder or (ii) any other corporation or other business entity (whether or not itself an Interested Shareholder) which is, or after such merger or consolidation would be, an Affiliate of an Interested Shareholder; or

6.3.4.2 any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions) to or with any Interested Shareholder or any Affiliate of any Interested Shareholder of any assets of the corporation or any Subsidiary having an aggregate Fair Market Value of ten percent (10%) or more of the total value of the assets of the corporation reflected in the most recent balance sheet of the corporation; or

6.3.4.3 the issuance or transfer by the corporation or any Subsidiary (in one transaction or a series of transactions) of any securities of the corporation or any Subsidiary to any Interested Shareholder or any Affiliate of any Interested Shareholder in exchange for cash, securities or other property (or a combination thereof) having an aggregate Fair Market Value of twenty percent (20%) of shareholders' equity or more; or

6.3.4.4 the adoption of any plan or proposal for the liquidation or dissolution of the corporation proposed by or on behalf of any Interested Shareholder or any Affiliate of any Interested Shareholder; except that this provision shall not limit the right of the shareholders to elect voluntarily to wind up or dissolve the corporation by the vote of shareholders holding shares of stock representing fifty percent (50%) or more of the stock then entitled to vote in the election of directors; or

6.3.4.5 any reclassification of the corporation's securities (including any reverse stock split), or recapitalization of the corporation, or any merger or consolidation of the corporation with any of its Subsidiaries or any other transaction (whether or not with or into or otherwise involving any Interested Shareholder) which has the effect, directly or indirectly, of increasing the proportionate beneficial ownership of any Interested Shareholder or any Affiliate of any Interested Shareholder in the outstanding shares of any class of equity or convertible securities of the corporation or any Subsidiary.

6.3.5 "Affiliate," and "Associate" shall have the respective meanings ascribed to such terms in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as in effect on January 1, 2000.

6.3.6 "Disinterested Director" means any member of the Board of Directors who is unaffiliated with the Interested Shareholder and was a member of the Board of Directors prior to the time that the Interested Shareholder became an Interested Shareholder, and any successor of a Disinterested Director who is unaffiliated with the Interested Shareholder and is recommended to succeed a Disinterested Director by a majority of Disinterested Directors then on the Board of Directors.

6.3.7 "Fair Market Value" means as to the stock of this corporation the fair market value on the date in question of a share of such stock as determined by the Board of Directors in good faith; and in the case of property other than cash or stock, the fair market value of such property on the date in question as determined by the Board of Directors in good faith.

6.3.8 "Subsidiary" means any corporation of which a majority of any class of equity security is owned, directly or indirectly, by this corporation; provided, however, that for purposes of the definition of Interested Shareholder, the term "Subsidiary" shall mean only a corporation of which a majority of each class of equity security is owned directly or indirectly by this corporation.

In the event of any Business Combination in which this corporation survives, the phrase "other consideration to be received" as used in Section 6.1 of this Article 6 shall include the shares of stock of this corporation retained by the holders of such shares.

6.4 A majority of the directors shall have the power and duty to determine for the purposes of this Article 6, on the basis of information known to them after reasonable inquiry, (A) whether a person is an Interested Shareholder, (B) the number of shares of stock of this corporation beneficially owned by any person, (C) whether a person is an Affiliate or Associate of another, or (D) whether the assets which are the subject of any Business Combination constitute substantially all assets of this corporation. A majority of the directors shall have the further power to interpret all of the terms and provisions of this Article 6.

6.5 Nothing contained in this Article 6 shall be construed to relieve any Interested Shareholder from any fiduciary obligation imposed by law.

6.6 Notwithstanding any other provisions of these Articles of Incorporation or the By-laws (and notwithstanding the fact that a lesser percentage may be specified by law, these Articles of Incorporation or the By-laws) the affirmative vote of the holders of at least sixty-six and two-thirds percent (66 2/3%) of the outstanding stock of this corporation shall be required to amend, repeal or adopt any provisions inconsistent with this Article 6.

ARTICLE 7

The Board of Directors, when evaluating any offer of another party to (a) make a tender or exchange offer for any Equity Security (as defined hereinafter) of the corporation, (b) merge or consolidate the corporation with another corporation, or (c) purchase, lease, or otherwise acquire all or substantially all of the property of the corporation, shall in connection with the exercise of its judgment in determining what is in the best interests of the corporation and its shareholders consider all of the following factors and any other factors it deems relevant: (i) the social and economic effects on the employees, shareholders, customers, suppliers, and other constituents of the corporation and its subsidiaries and on the communities in which the corporation or its subsidiaries operate or are located, including, without limitation, the availability of credit and other banking services to the communities served by the corporation; (ii) whether the proposed transaction might violate federal or state laws; and (iii) not only the consideration being offered in the proposed transaction in relation to the then current market price for or book value of the outstanding Common Stock of the corporation, but also to the market price for or book value of the Common Stock of the corporation over a period of years and the corporation's future value as an independent entity. For purposes of this Article 7, "Equity Security" shall have the meaning ascribed to such term in Section 3(a)(11) of the Securities Exchange Act of 1934, as in effect on January 1, 2000.

ARTICLE 8

The liability of directors of the corporation for monetary damages shall be eliminated to the fullest extent permissible under California law. The corporation is authorized to provide indemnification of agents (as defined in section 317 of the California Corporations Code) through bylaw provisions, agreements with agents, vote of shareholders or disinterested directors, or otherwise, to the fullest extent permissible under California law. Any amendment, repeal or modification of any provision of this Article 8 shall not adversely affect any right or protection of an agent of the corporation existing at the time of such amendment, repeal or modification.

**AMENDED AND RESTATED
BYLAWS OF
FIRST NORTHERN COMMUNITY BANCORP**
(As amended as of June 21, 2018)

**I
OFFICES**

1. Principal Office

The Board of Directors shall fix the location of the principal executive office of this Corporation at any place which is within Solano County, State of California.

2. Other Offices

The Board of Directors may at any time establish branch offices at any place or places where the Corporation is qualified to do business.

**II
MEETINGS OF SHAREHOLDERS**

3. Place of Meetings

Meetings of shareholders shall be held at any place within or outside Solano County, but within the State of California, designated by the Board of Directors. In the absence of any such designation, shareholders' meetings shall be held at the principal executive office of this Corporation.

4. Annual Meetings

The annual meeting of the shareholders shall be held each year on a date and at a time designated by the Board of Directors. The date designated by the Board of Directors shall be within five months after the end of this Corporation's fiscal year and within 15 months after the last annual meeting.

5. Special Meetings

A special meeting of the shareholders may be called at any time by the Board of Directors, or by the Chairman of the Board, or by the President, or by one or more shareholders holding shares in the aggregate entitled to cast no less than 10% of the votes at the meeting. If a special meeting is called by any person or persons other than the Board of Directors, the request shall be in writing, specifying the time of the meeting and the general nature of the business proposed to be transacted. The request shall be delivered personally or sent by registered mail or by telegraphic or other facsimile transmission to one or more of the Chairman of the Board, the President, any vice president, or the Secretary of this Corporation. The officer receiving the request shall cause notice to be given promptly to the shareholders entitled to vote, in accordance with the provisions of sections 6 and 7 of these Bylaws, that a meeting will be held at the time requested by the person or persons calling the meeting not less than 35 nor more than 60 days after the receipt of the request. If the notice is not given within 20 days after receipt of the request, the person or persons requesting the meeting may give the notice. Nothing contained in this section shall be construed as limiting, fixing or affecting the time when a meeting of shareholders called by action of the Board of Directors may be held.

6. Notice of Shareholders' Meeting

All notices of meetings of shareholders shall be sent or otherwise given in accordance with section 7 of these Bylaws not less than 10 nor more than 60 days before the date and hour of the meeting. The notice shall specify the place, date and time of the meeting and (i) in the case of a special meeting, the general nature of the business to be transacted, or (ii) in the case of the annual meeting, those matters which the Board of Directors, at the time of giving the notice, intends to present for action by the shareholders. The notice of any meeting at which directors are to be elected shall include the name of any nominee or nominees whom, at the time of the notice, management intends to present for election. If action is proposed to be taken at any meeting for approval of (i) a contract or transaction in which a director has direct or indirect financial interest, pursuant to section 310 of the California Corporations Code (the "Code"), (ii) an amendment of the Articles of Incorporation of this Corporation, pursuant to section 902 of the Code, (iii) a reorganization of this Corporation, pursuant to section 1201 of the Code, (iv) a voluntary dissolution of this Corporation, pursuant to section 1900 of the Code, or (v) a distribution in dissolution other than in accordance with the rights of outstanding preferred shares, pursuant to section 2007 of the Code, the notice shall also state the general nature of that proposal.

7. Manner of Giving Notice

Notice of any meeting of shareholders shall be given either personally or by first-class mail or telegraphic or other written communication, charges prepaid, addressed to the shareholder at the address of that shareholder appearing on the books of this Corporation or given by the shareholder to the Corporation for the purpose of notice. If no such address appears on the Corporation's books or is given, notice shall be deemed to have been given if sent to that shareholder by first-class mail or telegraphic or other written communication to the Corporation's principal executive office, or if published at least once in a newspaper of general circulation in the county where that office is located. Notice shall be deemed to have been given at the time when delivered personally or deposited in the mail or sent by telegram or other means of written communication. If any notice addressed to a shareholder at the address of that shareholder appearing on the books of this Corporation is returned to the Corporation by the United States Postal Service marked to indicate that the United States Postal Service is unable to deliver the notice to the shareholder at that address, all future notices or reports shall be deemed to have been duly given without further mailing if these shall be available to the shareholder on written demand of the shareholder at the principal executive office of this Corporation for a period of one year from the date of the giving of the notice or report.

8. Affidavit of Notice

An affidavit of the mailing or other means of giving any notice of any shareholders' meeting shall be executed by the Secretary, assistant secretary, or any transfer agent of this Corporation giving the notice, and shall be filed and maintained in the records of this Corporation.

9. Agendas for Annual Meetings of Shareholders

At any annual meeting of shareholders only such business shall be conducted as shall have been properly brought before the meeting. To be properly brought before an annual meeting, business must be (i) specified in the notice of meeting (or any supplement thereto) given by, or at the direction of, the Board of Directors, (ii) otherwise properly brought before the meeting by, or at the direction of, the chairman of the meeting, or (iii) otherwise properly brought before the meeting by a shareholder entitled to vote at such meeting. For business to be properly brought before a meeting by a shareholder, the shareholder must have given timely notice thereof in writing to the Secretary of the Corporation and must have been a shareholder of record at the time such notice is given. To be timely, a shareholder's notice shall be delivered to or mailed and received at the principal executive offices of the Corporation not less than 70 days nor more than 90 days prior to the first anniversary date of the preceding year's annual meeting; provided, however, that in the event that the date of the annual meeting is advanced by more than 20 days, or delayed by more than 70 days, from such anniversary date, notice by the shareholder to be timely must be so delivered or mailed and received not earlier than 90 days prior to such annual meeting and not later than the close of business on the later of the 70 days prior to such annual meeting or the 10th day following the day on which public announcement of the date of such meeting is first made. Such shareholder's notice to the Secretary shall set forth (i) as to each matter the shareholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting and the reasons for conducting such business at the meeting, and (ii) as to the shareholder giving the notice (a) the name and record address of the shareholder, (b) the class and the number of shares of capital stock of the Corporation which are beneficially owned by the shareholder, (c) any material interest of the shareholder in such business and (d) whether the shareholder intends or is part of a group which intends to solicit proxies from other shareholders in support of such proposal and if part of a group, the names and addresses of such group members. No business shall be conducted at an annual meeting of shareholders unless proposed in accordance with the procedures set forth herein. The chairman of the meeting shall, if the facts warrant, determine and declare to the meeting that business was not properly brought before the meeting in accordance with the foregoing procedure and such business shall not be transacted. To the extent this section 9. shall be deemed by the Board of Directors or the United States Securities and Exchange Commission or any applicable bank regulatory authority, or finally adjudged by a court of competent jurisdiction, to be inconsistent with the right of shareholders to request inclusion of a proposal in the Corporation's proxy statement pursuant to Rule 14a-8 promulgated under the Securities Exchange Act of 1934, as amended, such rule shall prevail.

10. Quorum

The presence in person or by proxy of the holders of a majority of the shares entitled to vote at any meeting of shareholders shall constitute a quorum for the transaction of business. The shareholders present at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding the withdrawal of enough shareholders to leave less than a quorum, if any action taken, other than adjournment, is approved by at least a majority of the shares required to constitute a quorum.

11. Adjourned Meeting

Any shareholders' meeting, annual or special, whether or not a quorum is present, may be adjourned from time to time by the vote of the majority of the shares represented at that meeting, either in person or by proxy, but in the absence of a quorum, no other business may be transacted at that meeting, except as provided in section 10 of these Bylaws. When any meeting of shareholders, either annual or special, is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place are announced at a meeting at which the adjournment is taken, unless a new record date for the adjourned meeting is fixed, or unless the adjournment is for more than 45 days from the date set for the original meeting, in which case the Board of Directors shall set a new record date. Notice of any such adjourned meeting shall be given to each shareholder of record entitled to vote at the adjourned meeting in accordance with the provisions of sections 6 and 7 of these Bylaws. At any adjourned meeting, the Corporation may transact any business which might have been transacted at the original meeting.

12. Voting Generally

The shareholders entitled to vote at any meeting shall be determined in accordance with the provisions of section 17 of these Bylaws subject to the provisions of sections 702 to 704, inclusive, of the Code, which relate to voting shares held by a fiduciary, in the name of a corporation, or in joint ownership or subject to a voting trust. In the discretion of the chairman of the meeting, the shareholders vote may be by voice vote or by ballot; provided, however, that any election for directors must be by ballot if demanded by any shareholder before the voting has begun. On any matter other than elections of directors, any shareholder may vote part of the shares in favor of the proposal and refrain from voting the remaining shares or vote them against the proposal, but, if the shareholder fails to specify the number of shares which the shareholder is voting affirmatively, it will be conclusively presumed that the shareholder's approving vote is with respect to all shares that the shareholder is entitled to vote. If a quorum is present, the affirmative vote of the majority of the shares represented at the meeting and entitled to vote on any manner, other than the election of directors, shall be the act of the shareholders, unless the vote of a greater number or voting by classes is required by Code or by the Articles of Incorporation.

13. Cumulative Voting for Directors

At a shareholders' meeting at which directors are to be elected, no shareholder shall be entitled to cumulate votes, that is, to cast for any one or more candidates a number of votes greater than the number of the shareholder's shares, unless the candidates' names have been placed in nomination prior to commencement of the voting and a shareholder has given notice prior to commencement of the voting of the shareholder's intention to cumulate votes. If any shareholder has given such a notice, then every shareholder entitled to vote may cumulate votes for candidates in nomination and give one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which that shareholder's shares are entitled, or distribute the shareholder's votes on the same principle among all of the candidates, as the shareholder thinks fit. The candidates receiving the highest number of votes, up to the number of directors to be elected, shall be elected.

14. Waiver of Notice or Consent by Absent Shareholders

The transactions of any meeting of shareholders, either annual or special, however called and noticed, and wherever held, shall be as valid as though had at a meeting duly held after regular call and notice, if a quorum be present either in person or by proxy, and if, either before or after the meeting, each person entitled to vote, who was not present in person or by proxy, signs a written waiver of notice or a consent to a holding of the meeting, or an approval of the minutes. The waiver of notice or consent need not specify either the business to be transacted or the purpose of any annual or special meeting of shareholders, except that if action is taken or proposed to be taken for approval of any of those matters specified in the last sentence of section 6 of these Bylaws, the waiver or consent shall state the general nature of the proposal. All such waivers, consents or approvals shall be filed with the corporate records or made a part of the minutes of the meeting. Attendance by a person at a meeting shall also constitute a waiver of notice of that meeting, except when the person objects, at the beginning of the meeting to the transaction of any business because the meeting is not lawfully called or convened, and except that attendance at a meeting is not a waiver of any right to object to the consideration of matters not included in the notice of the meeting if that objection is expressly made at the meeting.

15. Shareholder Action by Written Consent without a Meeting

Any action which may be taken at any annual or special meeting of shareholders may be taken without a meeting and without prior notice, if a consent in writing, setting forth the action so taken, is signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take that action at a meeting at which all shares entitled to vote on that action were present and voted, provided that the Board of Directors of this Corporation, by resolution, shall have previously approved any such action. In the case of election of directors, a consent otherwise conforming to the requirements of the preceding sentence shall be effective only if signed by the holders of all outstanding shares entitled to vote for the election of directors; provided, however, that a director may be elected at any time to fill a vacancy on the Board of Directors that has not been filled by the directors and that was not created by the removal of a director by the written consent of the holders of a majority of the outstanding shares entitled to vote for the election of directors. All such consents shall be filed with the Secretary of this Corporation and shall be maintained in the corporate records. Any shareholder giving a written consent, or the shareholder's proxy holders, or a transferee of the shares or a personal representative of the shareholder or their respective proxy holders, may revoke the consent by a writing received by the Secretary of this Corporation before written consents of the number of shares required to authorize the proposed action have been filed with the Secretary.

16. Notice of Action Taken by Written Consent without a Meeting

If the consents of all shareholders entitled to vote have not been solicited in writing, and if the unanimous written consent of all such shareholders shall not have been received, the Secretary of this Corporation shall give prompt notice of the corporate action approved by the shareholders without a meeting. This notice shall be given in the manner specified in section 7 of these Bylaws. In the case of approval of (i) contracts or transactions in which a director has a direct or indirect financial interest, pursuant to section 310 of the Code, (ii) indemnification of agents of this Corporation, pursuant to section 317 of the Code, (iii) a reorganization of this Corporation, pursuant to section 1201 of the Code, and (iv) a distribution in dissolution other than in accordance with the rights of outstanding preferred shares, pursuant to section 2007 of the Code, the notice shall be given at least 10 days before the consummation of any action authorized by that approval.

17. Record Dates for Shareholder Notice, Voting, and Giving Consents

For purposes of determining the shareholders entitled to notice of any meeting or to vote or entitled to give consent to corporate action without a meeting, the Board of Directors may fix, in advance, a record date, which shall be not more than 60 days, nor less than 10 days, before the date of any such meeting nor more than 60 days before any such action without a meeting, and in this event only shareholders of record on the date so fixed are entitled to notice and to vote or to give consents, as the case may be, notwithstanding any transfer of any shares on the books of this Corporation after the record date, except as otherwise provided in the Articles of Incorporation or in the Code. If the Board of Directors does not fix a record date:

(a) The record date for determining shareholders entitled to notice of or to vote at a meeting of shareholders shall be at the close of business on the business day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the business day preceding the day on which the meeting is held.

(b) The record date for determining shareholders entitled to give consent to corporate action in writing without a meeting, (i) when no prior action by the Board of Directors has been taken, shall be the day on which the first written consent is given, or (ii) when prior action of the Board of Directors has been taken, shall be at the close of business on the day on which the Board of Directors adopts the resolution relating to that action, or the 60th day before the date of such other action, whichever is later.

18. Proxies

Every person entitled to vote for directors or on any other matter shall have the right to do so either in person or by one or more agents authorized by a written proxy signed by the person and filed with the Secretary of this Corporation. A proxy shall be deemed signed if the shareholder's name is placed on the proxy, whether by manual signature, typewriting, telegraphic transmission, or otherwise, by the shareholder or the shareholder's attorney in fact. A validly executed proxy which does not state that it is irrevocable shall continue in full force and effect unless (i) revoked by the person executing it, before the vote pursuant to that proxy, by a writing delivered to the Corporation stating that the proxy is revoked, or by a subsequent proxy executed by, or attendance at the meeting and voting in person by, the person executing the proxy; or (ii) written notice of the death or incapacity of the maker of that proxy is received by the Corporation before the vote pursuant to that proxy is counted; provided, however that no proxy shall be valid after the expiration of 11 months from the date of the proxy, unless otherwise provided in the proxy. The revocability of a proxy that states on its face that it is irrevocable shall be governed by the provisions of sections 705(e) and 705(f) of the Code.

19. Inspectors of Election

Before any meeting of shareholders, the Board of Directors may appoint any persons other than nominees for office to act as inspectors of election at the meeting or its adjournment. If no inspectors of election are so appointed, the chairman of the meeting may, and on the request of any shareholder or a shareholder's proxy shall, appoint inspectors of election at the meeting. The number of inspectors shall be either one or three. If inspectors are appointed at a meeting on the request of one or more shareholders or proxies, the holders of a majority of shares or their proxies present at the meeting shall determine whether one or three inspectors are to be appointed. If any person appointed as inspector fails to appear or fails or refuses to act, the chairman of the meeting may, and upon the request of any shareholder or a shareholder's proxy shall, appoint a person to fill that vacancy. These inspectors shall:

- (a) Determine the number of shares of outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, and the authenticity, validity, and effect of proxies;
 - (b) Receive votes, ballots, or consents;
 - (c) Hear and determine all challenges and questions in any way arising in connection with the right to vote;
 - (d) Count and tabulate all votes or consents;
 - (e) Determine the result; and
 - (f) Do any other acts that may be proper to conduct the election or vote with fairness to all shareholders.
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20. Conduct of Meetings

The date and time of the opening and the closing of the polls for each matter upon which the shareholders will vote at a meeting shall be announced at the meeting by the person presiding over the meeting. The Board of Directors may adopt by resolution such rules and regulations for the conduct of the meeting of shareholders as it shall deem appropriate. Except to the extent inconsistent with such rules and regulations as adopted by the Board of Directors, the chairman of any meeting of shareholders shall have the right and authority to prescribe such rules, regulations and procedures and to do all such acts as, in the judgment of such chairman, are appropriate for the proper conduct of the meeting. Such rules, regulations or procedures, whether adopted by the Board of Directors or prescribed by the chairman of the meeting, may include, without limitation, the following: (i) the establishment of an agenda or order of business for the meeting, (ii) rules and procedures for maintaining order at the meeting and the safety of those present, (iii) limitations on attendance at or participation in the meeting to shareholders of record of the Corporation, their duly authorized and constituted proxies or such other persons as the chairman of the meeting shall determine, (iv) restrictions on entry to the meeting after the time fixed for the commencement thereof, and (v) limitations on the time allotted to questions or comments by participants. Unless and to the extent determined by the Board of Directors or the chairman of the meeting, meetings of shareholders shall not be required to be held in accordance with the rules of parliamentary procedure.

**III
DIRECTORS**

21. Powers

Subject to the provisions of the Code and any limitations in the Articles of Incorporation and these Bylaws relating to action required to be approved by the shareholders or by the outstanding shares, the business and affairs of this Corporation shall be managed and all corporate powers shall be exercised by or under the direction of the directors.

22. Number and Qualification of Directors

The number of directors of this Corporation shall not be less than seven nor more than 13. The exact number of directors shall be fixed from time to time, within the limits specified in this Section 22 of these Bylaws, (i) by a resolution duly adopted by the Board of Directors; or (ii) by a bylaw or amendment thereof duly adopted by the vote of a majority of the shares entitled to vote represented at a duly held meeting at which a quorum is present, or by the written consent of the holders of a majority of the outstanding shares entitled to vote; or (iii) by approval of the shareholders (as defined in Section 153 of the Code). The indefinite number of directors may be changed by a duly adopted amendment to the Articles of Incorporation and this bylaw adopted by the vote of a majority of the shares entitled to vote represented at a duly held meeting at which a quorum is present, or by the written consent of the holders of a majority of the outstanding shares entitled to vote, provided that no amendment may change the stated maximum number of authorized directors to a number greater than two times the stated minimum number of directors minus one; and, further, no amendment shall change the minimum number of directors to be less than five nor the maximum number to be more than 25 directors. Subject to the foregoing provisions for changing the number of directors, the exact number of directors of this Corporation has been fixed at 11. No person shall be a member of the Board of Directors (a) who has not been a resident for a period of at least two years immediately prior to his or her election of a county in which any subsidiary of this Corporation maintains an office unless the election of such person shall be approved by the affirmative vote of at least two-thirds (2/3's) of the members of the Board of Directors of this Corporation then in office, or (b) who owns, together with his or her family residing with him or her, directly or indirectly, more than one percent of the outstanding shares of any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, or (c) who is a director, officer, employee, agent, nominee, or attorney of any banking corporation, affiliate, or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, unless (i) such person is a director, officer, employee, agent, nominee, or attorney of a "bank service company" as defined in the Bank Service Company Act, 12 U.S.C., Section 1861-1867(c), performing services for banks which own such bank service company, and (ii) the election of such person shall be approved by the affirmative vote of at least two-thirds (2/3's) of the members of the Board of Directors of this Corporation then in office, or (d) who has or is the nominee of anyone who has any contract, arrangement or understanding with any banking corporation, or affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, or with any officer, director, employee, agent, nominee, attorney or other representative of such covered entity, that he or she will reveal or in any way utilize information obtained as a director of this Corporation or that he or she will, directly or indirectly, attempt to effect or encourage any action of this Corporation.

23. Nomination of Directors

Nominations for election to the Board of Directors may be made by the Board of Directors or by any shareholder of any outstanding class of capital stock of the Corporation entitled to vote for the election of directors. Nominations, other than those made by the Board of Directors shall be made in writing and shall be delivered or mailed to the President of the Corporation not less than 30 days nor more than 60 days prior to any meeting of shareholders called for the election of directors, provided, however, that if less than 21 days' notice of the meeting is given to shareholders, such nomination shall be mailed or delivered to the President of the Corporation not later than the close of business on the seventh day following the day on which the notice of meeting was mailed. Such notification shall contain the following information as to each proposed nominee and as to each person, acting alone or in conjunction with one or more other persons, in making such nomination or in organizing, directing or financing such nomination or solicitation of proxies to vote for the nominee: (a) the name, age, residence address and business address of each proposed nominee and each such person and the date as of which such nominee commenced residency at such residence address; (b) the principal occupation or employment, the name, type of business and address of the organization or other entity in which such employment is carried on of each proposed nominee and of each such person; (c) if the proposed nominee is an attorney, a statement as to whether or not either he or she or any firm with whom he or she has a relationship as partner, associate, of counsel, employee, or otherwise, acts as legal counsel for any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation; (d) a statement as to each proposed nominee and a statement as to each such person stating whether the nominee or person concerned has been a participant in any proxy contest within the past ten years, and, if so, the statement shall indicate the principals involved, the subject matter of the contest, the outcome thereof, and the relationship of the nominee or person to the principals; (e) the amount of stock of the Corporation owned beneficially, directly or indirectly, by each proposed nominee or by members of his or her family residing with him or her and the names of the registered owners thereof; (f) the amount of stock of the Corporation owned of record but not beneficially by each proposed nominee or by members of his or her family residing with him or her and by each such person or by members of his or her family residing with him or her and the names of the beneficial owners thereof; (g) if any shares specified in (e) or (f) above were acquired in the last two years, a statement of the dates of acquisition and amounts acquired on each date; (h) a statement showing the extent of any borrowings to purchase shares of the Corporation specified in (e) or (f) above acquired within the preceding two years, and if funds were borrowed otherwise than pursuant to a margin account or bank loan in the regular course of business of a bank, the material provisions of such borrowings and the names of the lenders; (i) the details of any contract, arrangement or understanding relating to the securities of the Corporation, to which each proposed nominee or to which each such person is a party, such as joint venture or option arrangements, puts or calls, guaranties against loss, or guaranties of profit or arrangements as to the division of losses or profits or with respect to the giving or withholding of proxies, and the name or names of the persons with whom such contracts, arrangements or understandings exist; (j) the details of any contract, arrangement, or understanding to which each proposed nominee or to which such person is a party with any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, or with any officer, director, employee, agent, nominee, attorney, or other representative of such covered entity; (k) a description of any arrangement or understanding of each proposed nominee and of each such person with any person regarding future employment or with respect to any future transaction to which the Corporation will or may be a party; (l) a statement as to each proposed nominee and a statement as to each such person as to whether or not the nominee or person concerned will bear any part of the expense incurred in any proxy solicitation, and, if so, the amount thereof; (m) a statement as to each proposed nominee and a statement as to each such person describing any conviction for a felony that occurred during the preceding ten years involving the unlawful possession, conversion or appropriation of money or other property, or the payment of taxes; (n) the total number of shares that will be voted for each proposed nominee; (o) the amount of stock, if any, owned, directly or indirectly, by each proposed nominee or by members of his or her family residing with him or her, in any banking corporation, affiliate or subsidiary thereof, bank holding company, industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation; and (p) the identity of any banking corporation, affiliate or subsidiary thereof, or bank holding company or industrial loan company, savings bank or association or finance company, other than this Corporation or any affiliate or subsidiary of this Corporation, as to which such nominee or any other such person serves as a director, officer, employee, agent, consultant, advisor, nominee or attorney, together with a description of such relationship.

24. Election and Term of Office of Directors

The chairman of the meeting may, in his or her discretion, determine and declare to the meeting that a nomination not made in accordance with the foregoing procedure shall be disregarded. The Directors shall be elected at each annual meeting of the shareholders to hold office until the next annual meeting or until the director has reached the mandatory retirement age of 72 years (or, if approved by the Board of Directors by resolution, at the adjournment of the first meeting of the Board of Directors following his or her 72nd birthday), died, resigned or been removed, whichever occurs first.

25. Vacancies

Vacancies in the Board of Directors may be filled by a majority of the remaining directors, though less than a quorum, or by a sole remaining director, except that a vacancy created by the removal of a director by the vote or written consent of the shareholders or by court order may be filled only by the vote of a majority of the shares entitled to vote represented at a meeting at which a quorum is present, or by the written consent of holders of all of the outstanding shares entitled to vote. Each director so elected shall hold office until the next annual meeting of the shareholders and until a successor has been elected and qualified. A vacancy or vacancies in the Board of Directors shall be deemed to exist in the event of a director's 72nd birthday (or, if approved by the Board of Directors by resolution, at the adjournment of the first meeting of the Board of Directors following his or her 72nd birthday), death, resignation, or removal, or if the Board of Directors by resolution declares vacant the office of a director who has been declared of unsound mind by an order of court or convicted of a felony, or if the authorized number of directors is increased, or if the shareholders fail, at any meeting of shareholders at which any director or directors are elected, to elect the number of directors to be voted for at that meeting. The shareholders may elect a director or directors at any time to fill any vacancy or vacancies not filled by the directors, but any such election by written consent and not involving a vacancy created by removal shall require the consent of a majority of the outstanding shares entitled to vote.

26. Resignation

Any director may resign effective on giving written notice to the Chairman of the Board, the President, the Secretary, or the Board of Directors, unless the notice specifies a later time for that resignation to become effective. If the resignation of a director is effective at a future time, the Board of Directors may elect a successor to take office when the resignation becomes effective. No reduction of the authorized number of directors shall have the effect of removing any director before that director's term of office expires.

27. Place of Meetings and Meetings by Telephone

Regular meetings of the Board of Directors may be held at any place within the State of California that has been designated from time to time by resolution of the Board of Directors. In the absence of such a designation, regular meetings shall be held at the principal executive office of this Corporation. Special meetings of the Board of Directors shall be held at any place within the State of California that has been designated in the notice of the meeting or, if not stated in the notice or there is no notice, at the principal executive office of this Corporation. Any meeting, regular or special, may be held by conference telephone or similar communication equipment, so long as all directors participating in the meeting can hear one another, and all such directors shall be deemed to be present in person at the meeting.

28. Annual Meetings

Within 30 days after each annual meeting of shareholders, the Board of Directors shall hold a regular meeting for the purpose of organization and the transaction of other business. Notice of this meeting shall not be required.

29. Other Regular Meetings

Other regular meetings of the Board of Directors shall be held without call at such time as shall from time to time be fixed by the Board of Directors. Such regular meetings may be held without notice.

30. Special Meetings

Special meetings of the Board of Directors for any purpose may be called at any time by the Chairman of the Board or the President or the Secretary.

31. Notice of Special Meetings

Notice of the time and place of special meetings shall be delivered personally or by telephone (including a voice messaging system or other system or technology designed to record and communicate messages), electronic mail or other electronic means to each director or sent by first-class mail or telegram, charges prepaid, addressed to each director at that director's address as it is shown on the records of this Corporation. In case the notice is mailed, it shall be deposited in the United States mail at least four days before the time of the holding of the meeting. In case the notice is delivered personally or by telephone or telegram, it shall be delivered personally or by telephone (including voice messaging or other system or technology), electronic mail or other electronic means or to the telegraph company at least 24 hours before the time of the holding of the meeting. Any oral notice given personally or by telephone (including voice messaging or other system or technology), electronic mail or other electronic means may be communicated either to the director or to a person at the office of the director who the person giving the notice has reason to believe will promptly communicate it to the director. The notice need not specify the purpose of the meeting nor the place if the meeting is to be held at the principal executive office of this Corporation.

32. Quorum

A majority of the authorized number of directors shall constitute a quorum for the transaction of business, except to adjourn as provided in section 34 of these Bylaws. Every act or decision done or made by a majority of the directors present at a meeting held at which a quorum is present shall be regarded as the act of the Board of Directors, subject to the provisions of section 310 of the Code as to approval of contracts or transactions in which a director has a direct or indirect material financial interest, section 311 of the Code as to appointment of committees, and section 317(e) of the Code as to indemnification of directors. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting.

33. Waiver of Notice

The transactions of any meeting of the Board of Directors, however called and noticed or wherever held, shall be as valid as though had at a meeting held after regular call and notice if a quorum is present and if, either before or after the meeting, each of the directors not present signs a written waiver of notice, a consent to holding the meeting or an approval of the minutes. The waiver of notice or consent need not specify the purpose of the meeting. All such waivers, consents, and approvals shall be filed with the corporate records or made a part of the minutes of the meeting. Notice of the meeting shall also be deemed given to any director who attends the meeting without protesting before or at its commencement the lack of notice to that director.

34. Adjournment

A majority of the directors present, whether or not constituting a quorum, may adjourn any meeting to another time and place.

35. Notice of Adjournment

Notice of the time and place of holding an adjourned meeting need not be given, unless the meeting is adjourned for more than 24 hours, in which case notice of the time and place shall be given before the time of the adjourned meeting in the manner specified in section 31 of these Bylaws, to the directors who were not present at the time of the adjournment.

36. Action without Meeting

Any action required or permitted to be taken by the Board of Directors may be taken without a meeting, if all members of the Board of Directors shall individually or collectively consent in writing to that action. Such action by written consent shall have the same force and effect as a unanimous vote of the Board of Directors. Such written consent or consents shall be filed with the minutes of the proceedings of the Board of Directors.

37. Fees and Compensation of Directors

Directors and members of committees may receive such compensation for their services, and such reimbursement of expenses, as may be fixed by the Board of Directors. This section shall not be construed to preclude any director from serving the Corporation in any other capacity as an officer, agent, employee, or otherwise and receiving compensation for those services.

IV COMMITTEES

38. Committees of Directors

The Board of Directors may, by resolution adopted by a majority of the authorized number of directors, designate one or more committees, each consisting of two or more directors, to serve at the pleasure of the Board of Directors. The Board of Directors may designate one or more directors as alternate members of any committee, who may replace any absent member at any meeting of the committee. Any committee, to the extent provided in the resolution of the Board of Directors, shall have all the authority of the Board of Directors, except with respect to:

- (a) the approval of any action which, under the Code, also requires shareholders' approval or approval of the outstanding shares;
- (b) the filling of vacancies on the Board of Directors or on any committee;
- (c) the fixing of compensation of the directors for serving on the Board of Directors or on any committee;
- (d) the amendment or repeal of Bylaws or the adoption of new Bylaws;
- (e) the amendment or repeal of any resolution of the Board of Directors which by its express terms is not so amendable or repealable;
- (f) a distribution to the shareholders of this Corporation, except at a rate or in a periodic amount or within a price range determined by the Board of Directors;
- (g) the appointment of any other committees of the Board of Directors or the members of these committees; or
- (h) the taking of any other action which cannot, by statute, be done without approval of the Board of Directors.

39. Meetings and Action of Committees

Meetings and action of committees shall be governed by and held and taken in accordance with the provisions of section 27 of these Bylaws as to place of meetings, section 29 of these Bylaws as to regular meetings, section 30 of these Bylaws as to special meetings, section 31 of these Bylaws as to notice of special meetings, section 32 of these Bylaws as to quorum, section 33 of these Bylaws as to waiver of notice, section 34 of these Bylaws as to adjournment, and section 36 of these Bylaws as to action without a meeting, with such changes in the context of those sections as are necessary to substitute the committee and its members for the Board of Directors and its members, except that the time of regular meetings of committees may be determined either by resolution of the Board of Directors or by resolution of the committee; special meetings of committees may also be called by resolution of the Board of Directors; and notice of special meetings of committees shall also be given to all alternate members who shall have the right to attend all meetings of the committee. The Board of Directors may adopt rules for the government of any committee not inconsistent with the provisions of these Bylaws.

V OFFICERS

40. Officers

The officers of this Corporation shall be a President, a Secretary, a Chief Financial Officer and a Chairman of the Board. The Corporation may also have, at the discretion of the Board of Directors, a Vice Chairman, one or more vice presidents, one or more assistant secretaries, one or more assistant treasurers, and such other officers as may be appointed in accordance with the provisions of section 42 of these Bylaws. Any number of offices may be held by the same person.

41. Election of Officers

The officers of this Corporation, except such officers as may be appointed in accordance with the provisions of sections 42 or 44 of these Bylaws, shall be chosen by the Board of Directors and each shall serve at the pleasure of the Board of Directors, subject to the rights, if any, of an officer under any contract of employment.

42. Subordinate Officers

The Board of Directors may appoint, and may empower the President to appoint, such other officers as the business of this Corporation may require, each of whom shall hold office for such period, have such authority and perform such duties as are provided in the Bylaws or as the Board of Directors may from time to time determine.

43. Removal and Resignation of Officers

Subject to the rights, if any, of an officer under any contract of employment, any officer may be removed, either with or without cause, by the Board of Directors, at any regular or special meeting of the Board of Directors, or, except in case of an officer chosen by the Board of Directors, by any officer upon whom such power of removal may be conferred by the Board of Directors. Any officer may resign at any time by giving written notice to the Corporation. Any resignation shall take effect at the date of the receipt of that notice or at any later time specified in that notice; and, unless otherwise specified in that notice, the acceptance of the resignation shall not be necessary to make it effective. Any resignation is without prejudice to the rights, if any, of this Corporation under any contract to which the officer is a party.

44. Vacancies in Offices

A vacancy in any office because of death, resignation, removal, disqualification or any other cause shall be filled in the manner prescribed in these Bylaws for regular appointments to that office.

45. Chairman of the Board

The Chairman of the Board shall, if present, preside at meetings of the Board of Directors, and exercise and perform such other powers and duties as may be from time to time assigned to him or her by the Board of Directors or prescribed by the Bylaws.

46. Vice Chairman

In the absence or disability of the Chairman, the Vice Chairman, if any, shall perform all the duties of the Chairman of the Board. The Vice Chairman shall have such other powers and duties as may be prescribed by the Board of Directors or these Bylaws

47. President

Subject to such supervisory powers, if any, as may be given by the Board of Directors to the Chairman of the Board, the President shall be the chief executive officer of this Corporation and shall, subject to the control of the Board of Directors, have general supervision, direction and control of the business and the officers of this Corporation. The President shall preside at all meetings of the shareholders and, in the absence of the Chairman of the Board, at all meetings of the Board of Directors. The President shall have the general duties of management usually vested in the office of the President of a Corporation, and shall have such other powers and duties as may be prescribed by the Board of Directors or these Bylaws.

48. Vice Presidents

In the absence or disability of the President, the vice presidents, if any, in order of their rank as fixed by the Board of Directors or, if not ranked, a vice president designated by the Board of Directors, shall perform all the duties of the President, and when so acting shall have all the powers of, and be subject to all the restrictions upon, the President. The vice presidents shall have such other powers and perform such other duties as from time to time may be prescribed for them respectively by the Board of Directors or the Bylaws, and the President, or the Chairman of the Board.

49. Secretary

The Secretary shall keep or cause to be kept, at the principal executive office or such other place as the Board of Directors may direct, a book of minutes of all meetings and actions of directors, committees of directors, and shareholders, with the time and place of holding, whether regular or special and, if special, how authorized, the notice given, the names of those present at directors' meetings or committee meetings, the number of shares present or represented at shareholders' meetings, and the proceedings. The Secretary shall keep, or cause to be kept, at the principal executive office or at the office of this Corporation's transfer agent or registrar, as determined by the resolution of the Board of Directors, a share register, or a duplicate share register, showing the names of all shareholders and their addresses, the number and classes of shares held by each, the number and date of certificates issued for the same, and the number and date of cancellation of every certificate surrendered for cancellation. The Secretary shall give, or cause to be given, notice of all meetings of the shareholders and of the Board of Directors required by the Bylaws or by law to be given, and shall have such other powers and perform such other duties as may be prescribed by the Board of Directors or by the Bylaws, the President or the Chairman of the Board.

50. Chief Financial Officer

The Chief Financial Officer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and records of accounts of the properties and business transactions of this Corporation, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, retained earnings, and shares. The books of account shall at all reasonable times be open to inspection by any director. The Chief Financial Officer shall deposit all moneys and other valuables in the name and to the credit of this Corporation with such depositories as may be designated by the Board of Directors. The Chief Financial officer shall disburse the funds of this Corporation as may be ordered by the Board of Directors, shall render to the President and directors, whenever they request it, an account of all of his or her transactions as Chief Financial Officer and of the financial condition of this Corporation, and shall have other powers and perform such other duties as may be prescribed by the Board of Directors or the Bylaws, the President or the Chairman of the Board.

VI
INDEMNIFICATION OF DIRECTORS, OFFICERS,
EMPLOYEES AND OTHER AGENTS

51. Agents, Proceedings and Expenses

For the purposes of the following eight sections, “agent” means any person who is or was a director, officer, employee, or other agent of this Corporation, or is or was serving at the request of this Corporation as a director, officer, employee or agent of another foreign or domestic corporation, partnership, joint venture, trust or other enterprise, or was a director, officer, employee, or agent of a foreign or domestic corporation which was a predecessor corporation of this Corporation or of another enterprise at the request of such predecessor corporation; “proceeding” means any threatened, pending or completed action or proceeding, whether civil, criminal, administrative, or investigative; and “expenses” includes, without limitation, attorneys’ fees and any expenses of establishing a right to indemnification under this Article VI.

52. Actions Other Than by the Corporation

This Corporation shall indemnify any person who was or is a party, or is threatened to be made a party, to any proceeding, other than an action by or in the right of this Corporation, by reason of the fact that the person is or was an agent of this Corporation, against expenses, judgments, fines, settlements and other amounts actually and reasonably incurred in connection with such proceeding if that person acted in good faith and in a manner reasonably believed to be in the best interests of this Corporation and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful. The termination of any proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner reasonably believed to be in the best interests of this Corporation or that the person had reasonable cause to believe that the conduct was unlawful.

53. Actions by the Corporation

This Corporation shall indemnify any person who was or is a party, or is threatened to be made a party, to any threatened, pending or completed action by or in the right of this Corporation to procure a judgment in its favor by reason of the fact that that person is or was an agent of this Corporation, against expenses actually and reasonably incurred in connection with the defense or settlement of that action if that person acted in good faith, in a manner believed to be in the best interests of this Corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. No indemnification shall be made under this section:

- (a) in respect of any claim, issue, or matter as to which that person shall have been adjudged to be liable to this Corporation in the performance of duty to this Corporation, unless and only to the extent that the court in which that action was brought shall determine upon application that, in view of all the circumstances of the case, that person is fairly and reasonably entitled to indemnity for the expenses which the court shall determine; or
- (b) of amounts paid in settling or otherwise disposing of a threatened or pending action, with or without court approval; or
- (c) of expenses incurred in defending a threatened or pending action which is settled or otherwise disposed of without court approval.

54. Successful Defense by Agent

To the extent that an agent of this Corporation has been successful on the merits in defense of any proceeding referred to in sections 52 or 53 of these Bylaws, or in defense of any claim, issue, or matter therein, the agent shall be indemnified against expenses actually and reasonably incurred by the agent in connection therewith.

55. Required Approval

Except as provided in section 54 of these Bylaws, indemnification shall be made by this Corporation only if authorized in the specific case on a determination that indemnification of the agent is proper in the circumstances because the agent has met the applicable standard of conduct set forth in sections 52 or 53 of these Bylaws by:

- (a) a majority vote of a quorum consisting of directors who are not parties to the proceeding;
- (b) approval by the affirmative vote of a majority of the shares of this Corporation entitled to vote represented at a duly held meeting at which a quorum is present or by the written consent of holders of a majority of the outstanding shares entitled to vote. For this purpose, the shares owned by the person to be indemnified shall not be considered outstanding or entitled to vote thereon; or
- (c) the court in which the proceeding is or was pending on application made by this Corporation or the agent or the attorney or other person rendering services in connection with the defense, whether or not such application by the agent, attorney, or other person is opposed by this Corporation.

56. Advance of Expenses

Expenses incurred by any agent in defending any proceeding for which indemnification is required by this Article VI shall be advanced by this Corporation before the final disposition of the proceeding on receipt of an undertaking by or on behalf of the agent to repay that amount unless it shall ultimately be determined that the agent is entitled to be indemnified under this Article VI.

57. Other Contractual Rights

Nothing contained herein shall affect any right to indemnification to which persons other than directors and officers of this Corporation or any subsidiary hereof may be entitled by contract or otherwise.

58. Limitations

No indemnification or advance shall be made, except as provided in section 54 or section 55(c), in any circumstance where it appears:

- (a) that it would be inconsistent with a provision of the articles, a resolution of the shareholders, or an agreement in effect at the time of the accrual of the alleged cause of action asserted in the proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification; or
- (b) that it would be inconsistent with any condition expressly imposed by a court in approving a settlement.

59. Insurance

The Board of Directors of this Corporation may purchase and maintain insurance on behalf of any agent of this Corporation against any liability asserted against or incurred by the agent in such capacity or arising out of the agent's status as such whether or not this Corporation would have the power to indemnify the agent against that liability under the provisions of this section.

60. Fiduciaries of Corporate Employee Benefit Plans

The foregoing indemnification provisions do not apply to any proceeding against any trustee, investment manager, or other fiduciary of an employee benefit plan in that person's capacity as such, even though that person may also be an agent of this Corporation as above. Nothing contained herein shall limit any right to indemnification to which such a trustee, investment manager, or other fiduciary may be entitled by contract or otherwise, which shall be enforceable to the extent permitted by applicable law.

**VII
RECORDS AND REPORTS**

61. Maintenance and Inspection of Share Register

The Corporation shall keep at its principal executive office, or at the office of its transfer agent or registrar, if either be appointed, a record of its shareholders, giving names and addresses of all shareholders and the number and class of shares held by each shareholder. A shareholder or shareholders of this Corporation holding at least five percent in the aggregate of the outstanding voting shares of this Corporation may (i) inspect and copy the records of shareholders' names and addresses and shareholdings during usual business hours on five days prior written demand on the Corporation, and (ii) obtain, on written demand and on the tender of the usual charges for such list, a list of the shareholders' names and addresses who are entitled to vote for the election of directors, and their shareholdings, as of the most recent record dates for which that list has been compiled or as of a date specified by the shareholder after the date of demand. This list shall be made available to any such shareholder on or before the later of five days after the demand is received, or the date specified in the demand as the date as of which the list is to be compiled. The record of shareholders shall also be open to inspection on the written demand of any shareholder or holder of a voting trust certificate, at any time during usual business hours, for a purpose reasonably related to the holder's interests as a shareholder or as the holder of a voting trust certificate. Any inspection and copying under this section may be made in person or by an agent or attorney of the shareholder or holder of a voting trust certificate making the demand.

62. Maintenance and Inspection of Bylaws

The Corporation shall keep at its principal executive office the original or a copy of the Bylaws as amended to date, which shall be open to inspection by the shareholders at all reasonable times during office hours.

63. Maintenance and Inspection of Other Corporate Records

The accounting books and records and minutes of proceedings of the shareholders and the Board of Directors and any committee or committees of the Board of Directors shall be kept at such place or places designated by the Board of Directors or, in the absence of such designation, at the principal executive office of this Corporation. The minutes shall be kept in written form and the accounting books and records shall be kept in either written form or in any other form capable of being converted into written form. The minutes and accounting books and records shall be open to inspection upon the written demand of any shareholder or holder of a voting trust certificate, at any reasonable time during usual business hours, for a purpose reasonably related to the holder's interests as a shareholder or as the holder of a voting trust certificate. The inspection may be made in person or by an agent or attorney, and shall include the right to copy and make extracts. No such right of inspection shall extend to any confidential information relating to the depositors, borrowers or other customers of this Corporation or other information which the Corporation may not disclose under applicable law or lawful agreements with third parties.

64. Inspection by Directors

Every director shall have the absolute right at any reasonable time to inspect all books, records and documents of every kind and the physical properties of this Corporation. This inspection by a director may be made in person or by an agent or attorney and the right of inspection includes the right to copy and make extracts of documents.

65. Annual Report to Shareholders

The Board of Directors shall cause an annual report to be sent to the shareholders not later than 120 days after the close of the fiscal year adopted by the Corporation. This report shall be sent at least 15 days before the annual meeting of shareholders to be held during the next fiscal year and in the manner specified for giving notice to shareholders of this Corporation. The annual report shall contain a balance sheet as of the end of the fiscal year and an income statement and statement of changes in financial position for the fiscal year, accompanied by any report of independent accountants or, if there is no such report, the certificate of an authorized officer of this Corporation that the statements were prepared without audit from the books and records of this Corporation.

66. Financial Statements

A copy of any annual financial statement and any income statement of this Corporation for each quarterly period of each fiscal year, and any accompanying balance sheet of this Corporation as of the end of each such period, that has been prepared by the Corporation shall be kept in the principal executive office of this Corporation for 12 months and each such statement shall be exhibited at all reasonable times to any shareholder demanding an examination of any such statement or a copy shall be mailed to any such shareholder. If a shareholder or shareholders holding at least five percent of the outstanding shares of any class of stock of this Corporation makes a written request to the Corporation for an income statement of this Corporation for the three-month, six-month or nine-month period of the then current fiscal year ended more than 30 days before the date of the request, and a balance sheet of this Corporation as of the end of that period, the Chief Financial Officer shall cause that statement to be prepared, if not already prepared, and shall deliver personally or mail that statement or statements to the person making the request within 30 days after the receipt of the request. If the Corporation has not sent to the shareholders its annual report for the last fiscal year, this report shall likewise be delivered or mailed to the shareholder or shareholders within 30 days after the request. The Corporation shall also, on the written request of any shareholder, mail to the shareholder a copy of the last annual, semi-annual, or quarterly income statement which it has prepared, and a balance sheet as of the end of that period. The quarterly income statements and balance sheets referred to in this section shall be accompanied by the report, if any, of any independent accountants engaged by the Corporation or the certificate of an authorized officer of this Corporation that the financial statements were prepared without audit from the books and records of this Corporation.

67. Annual Statement of General Information

The Corporation shall each year file with the Secretary of the State of California, on the prescribed form, a statement setting forth the authorized number of directors, the names and complete business or residence addresses of all incumbent directors, the number of vacancies on the Board of Directors, if any, the names and complete business or residence addresses of the chief executive officer, Secretary, and Chief Financial Officer, the street address of its principal executive office or principal business office in this state, and the general type of business constituting the principal business activity of this Corporation, together with a designation of the agent of this Corporation for the purpose of service of process, all in compliance with section 1502 of the Code.

**VIII
GENERAL CORPORATE MATTERS**

68. Record Date for Purposes Other Than Notice and Voting

For purposes of determining the shareholders entitled to receive payment of any dividend or other distribution or allotment of any rights or entitled to exercise any rights in respect of any other action, other than action by shareholders by written consent without a meeting, the Board of Directors may fix, in advance, a record date, which shall not be more than 60 days before any such action, and in that case only shareholders of record on the date so fixed are entitled to receive the dividend, distribution or allotment of rights or to exercise the rights, as the case may be, notwithstanding any transfer of any shares on the books of this Corporation after the record date as fixed, except as otherwise provided in the Code. If the Board of Directors does not fix a record date, the record date for determining shareholders for any such purpose shall be at the close of business on the day on which the Board of Directors adopts the applicable resolution or the 60th day before the date of that action, whichever is later.

69. Checks, Drafts, Evidences of Indebtedness

All checks, drafts, or other orders for payment of money, notes, or other evidences of indebtedness, issued in the name of or payable to the Corporation, shall be signed or endorsed by such person or persons and in such manner as, from time to time, shall be determined by resolution of the Board of Directors.

70. Corporate Contracts and Instruments, Execution of

The Board of Directors, except as otherwise provided in these Bylaws, may authorize any officer or officers, agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of this Corporation and this authority may be general or confined to specific instances; and, unless so authorized or ratified by the Board of Directors, or within the agency power of an officer, no officer, agent, or employee shall have any power or authority to bind the Corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or for any amount.

71. Certificate for Shares

A certificate or certificates for shares of the capital stock of this Corporation shall be issued to each shareholder when any of these shares are fully paid. All certificates shall be signed in the name of this Corporation by the Chairman of the Board, or the President or vice president, and by the Chief Financial Officer or the Secretary or an assistant secretary, certifying the number of shares and the class or series of shares owned by the shareholder. Any or all of the signatures on the certificate may be facsimile. In case any officer, transfer agent, or registrar who has signed or whose facsimile signature has been placed on a certificate shall have ceased to be that officer, transfer agent, or registrar before that certificate is issued, it may be issued by the Corporation with the same effect as if that person were an officer, transfer agent, or registrar at the date of issue.

72. Lost Certificates

Except as provided in this section, no new certificates for shares shall be issued to replace an old certificate unless the latter is surrendered to the Corporation and cancelled at the same time. The Board of Directors may, in case any share certificate or certificate for any other security is lost, stolen, or destroyed, authorize the issuance of a replacement certificate on such terms and conditions as the Board of Directors may require, including provision for indemnification of this Corporation secured by a bond or other adequate security sufficient to protect the Corporation against any claim that may be made against it, including any expense or liability, on account of the alleged loss, theft or destruction of the certificate or the issuance of the replacement certificate.

73. Representation of Shares of Other Corporations

The Chairman of the Board, the President, the Chief Financial Officer or any other person authorized by resolution of the Board of Directors or by any of the foregoing designated officers, is authorized to vote on behalf of this Corporation any and all shares of any other corporation or corporations, foreign or domestic, standing in the name of this Corporation. The authority granted to these officers to vote or represent on behalf of this Corporation any and all shares held by the Corporation in any other corporation or corporations may be exercised by any of these officers in person or by any person authorized to do so by a proxy duly executed by these officers.

74. Construction and Definitions

Unless the context requires otherwise, the general provisions, rules of construction and definitions in the Code shall govern the construction of these Bylaws.

**IX
AMENDMENTS**

75. Amendment by Shareholders

New Bylaws may be adopted or these Bylaws may be amended or repealed by the vote or written consent of holders of a majority of the outstanding shares entitled to vote.

76. Amendment by Directors

Subject to the rights of the shareholders as provided in section 75 of these Bylaws, Bylaws may be adopted, amended, or repealed by the Board of Directors; provided, however, that the Board of Directors may adopt a bylaw or amendment of a bylaw changing the authorized number of directors only for the purpose of fixing the exact number of directors within the limits specified in the Articles of Incorporation or in section 22 of these Bylaws.

SUBSIDIARIES OF THE COMPANY

First Northern Community Bancorp

Subsidiaries as of December 31, 2018

First Northern Bank of Dixon

State of Incorporation
California

Consent of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
First Northern Community Bancorp

We consent to the incorporation by reference in the Registration Statements (Form S-8, No. 333-37874, No. 333-136977, and No. 333-207951) of First Northern Community Bancorp of our report dated March 8, 2019, relating to the consolidated financial statements of First Northern Community Bancorp as of December 31, 2018 and 2017 and for each of the three years in the period ended December 31, 2018, and the effectiveness of internal control over financial reporting as of December 31, 2018, which report appears in the Annual Report on Form 10-K of First Northern Community Bancorp for the year ended December 31, 2018.

/s/ MOSS ADAMS LLP

Los Angeles, California
March 8, 2019

Rule 13(a) – 14(a) / 15(d) –14(a) Certification

I, Louise A. Walker, certify that:

1. I have reviewed this annual report on Form 10-K of First Northern Community Bancorp;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and
 - d) disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 8, 2019

/s/ Louise A. Walker

Louise A. Walker
President and Chief Executive Officer

Rule 13(a) – 14(a) / 15(d) –14(a) Certification

I, Kevin Spink, certify that:

1. I have reviewed this annual report on Form 10-K of First Northern Community Bancorp;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this annual report based on such evaluation; and
 - d) disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 8, 2019

/s/ Kevin Spink

Kevin Spink
Executive Vice President/
Chief Financial Officer

CERTIFICATION PURSUANT TO 18 U.S.C. § 1350

In connection with the filing of the Annual Report of First Northern Community Bancorp (the "Company") on Form 10-K for the year ended December 31, 2018 (the "Report"), I, Louise A. Walker, the Chief Executive Officer of the Company, certify pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge,

- (i) the Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 8, 2019

/s/ Louise A. Walker

Louise A. Walker
President and Chief Executive Officer

CERTIFICATION PURSUANT TO 18 U.S.C. § 1350

In connection with the filing of the Annual Report of First Northern Community Bancorp (the "Company") on Form 10-K for the year ended December 31, 2018 (the "Report"), I, Kevin Spink, the Chief Financial Officer of the Company, certify pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge,

- (i) the Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 8, 2019

/s/ Kevin Spink

Kevin Spink
Executive Vice President /
Chief Financial Officer